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Politics this week

May 16th 2002
From The Economist print edition

Farewell to arms

A week before a planned meeting in Moscow between George Bush and Vladimir Putin, **NATO and Russia** agreed to form a new council to work jointly on terrorism, arms control and international crisis management, although the 19 NATO countries and Russia will all be free to go their own way if they cannot agree. Russia and the United States also agreed to reduce their strategic nuclear arsenals by two-thirds by the end of 2012.

See article: Arms control and summitry bring America and Russia closer

The White House admitted that last August the CIA warned Mr Bush that **al-Qaeda** was plotting to hijack aircraft. The disclosure comes shortly before a congressional inquiry into America's troubled intelligence service.

The Senate emasculated George Bush's attempt to get **fast-track trade authority** by excluding any changes to America's own trade rules. Mr Bush made a miserable week for free trade worse by signing into law a farm bill under which as much as $190 billion could be spent on supporting American farmers over the next ten years.

See article: How trade policy went

Jimmy Carter, a former American president, caused a stir on a visit to **Cuba**. In a speech broadcast live on television, he criticised restrictions on opponents of Fidel Castro's regime and spoke approvingly of a petition organised by dissidents that seeks to change the constitution to allow free speech and free elections.

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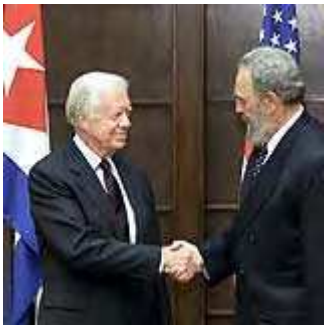

See article: Jimmy Carter visits Cuba

The woes of the Catholic church in America intensified. Cardinal Bernard Law admitted that he had transferred a **paedophile priest** to other parishes, despite knowing of his sins. A Catholic priest in Baltimore was shot and seriously wounded by a man who had previously accused him of sexual abuse.

The ruling Liberal party lost two safe seats in by-elections in **Canada**, increasing speculation that Jean Chrétien, the prime minister, might announce his retirement before the end of the year.

See article: Chrétien and on and on

The Dutch swing right

EPA

Voters in the **Netherlands** ended eight years of Labour-led centre-left domination by giving the centre-right Christian Democrats most seats in parliament, ahead of the anti-immigration Pim Fortuyn List named after its leader, who was assassinated last week. A right-wing coalition government including Fortuyn's followers seems likely.

See article: The Dutch swing to the right could affect all of Europe

Angry **Portuguese** took to the streets in protest against a decision by their new centre-right prime minister, Jose Manuel Durao Barroso, to revise the current budget by cutting public spending and raising VAT, in order to ensure that Portugal does not flout the deficit ceiling of 3% imposed by the euro-zone's stability pact.

See article: Portugal's strict new budget

Opinion pollsters say that France's re-elected president, **Jacques Chirac**, and his alliance of the mainstream right, gained ground after the president stalked out of a football stadium when the Marseillaise, France's national anthem, was booed by supporters of a Corsican team.

See article: President Jacques Chirac's fresh momentum

Strikes for a better pay deal by workers in **Germany's** biggest industrial trade union, IG Metall, ended with a settlement promising workers 4% extra this year and another 3.1% in June 2003.

See article: Guido Westerwelle, Germany's hopeful liberal

Ireland's incumbent prime minister, Bertie Ahern, and his right-wing Fianna Fail party, were tipped to win a general election on May 17th, perhaps coming close to winning an outright majority of seats.

Kofi Annan, the UN's secretary-general, paid a visit to the divided island of **Cyprus** in an attempt to break the deadlock in talks between the leaders of the Greek and Turkish communities.

Tension in Kashmir

Tension rose between **India and Pakistan** after more than 30 people were killed in an attack on an army camp near Jammu in Indian-administered Kashmir. Many of the dead were the wives and children of soldiers. India said that a Pakistani militant group carried out the attack and that it would respond. Pakistan condemned the attack.

See article: Terrorism in Kashmir

A field hospital for British soldiers stationed in **Afghanistan** was closed after 18 medical staff were taken ill with a mystery disease. Enemy action was discounted.

East Timor prepared to celebrate its independence at midnight on May 19th after centuries of foreign rule.

See article: East Timor's freedom

More than 400 people died in a week of **searing heat** in the southern Indian state of Andhra Pradesh.

In a move to combat ecological disturbances such as sandstorms and floods, **China** announced that it is to plant swathes of trees in six districts covering 500,000 square kilometres, an area larger than Germany.

Elected in peace

An election in **Sierra Leone** was held with a high turnout and without bloodshed, raising hopes that this war-ravaged country in West Africa may finally be on the mend. The incumbent, Ahmed Tejan Kabbah, was expected to win the presidency.

See article: An unlikely election in Sierra Leone

In neighbouring **Liberia**, rebels calling themselves Liberians United for Reconciliation and Democracy attacked close to the capital in a bid to oust President Charles Taylor.

In Zimbabwe, **tobacco farmers** refused to sell their crop, which is the country's main export, because the government insists on confiscating five-sixths of the proceeds through a rigged exchange rate.

The UN Security Council finally passed a unanimous resolution changing the procedure for administering sanctions on **Iraq**. The so-called “smart” sanctions allow Iraq to import whatever is not on a long list of “dual-use” items.

See article: Easing the sanctions on Iraq

In a speech to the Palestinian parliament, **Yasser Arafat** promised to overhaul his regime and to hold elections, though no timetable was proposed. Ariel Sharon has made reform of the Palestinian Authority a precondition for negotiation.

EPA

See article: Reforming the Palestinian Authority

Binyamin Netanyahu, Ariel Sharon's rival as Israel's right-wing leader, won a vote in Likud's central committee denouncing any form of Palestinian statehood. But Mr Sharon seems to have retained the support of the party's rank-and-file.

See article: Israel's squabbling Likud party

Israel's police continued to arrest suspects in connection with an alleged plot by **Jewish extremists** to blow up a Palestinian girls' school in East Jerusalem.

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Business this week

May 16th 2002
From The Economist print edition

On the airwaves

Vivendi Universal cheered investors and Rupert Murdoch alike with the news that it would sell its remaining 13% stake in BskyB, a British satellite-TV company. Vivendi will use the cash, around £1.7 billion ($2.5 billion), to pay off debt. Mr Murdoch's News Corp announced losses of $4 billion in its latest quarter, after writing off $4.2 billion of bad investments.

Mr Murdoch is heading for another row with Vivendi after Italian regulators agreed only with tough conditions to a merger between **Telepiu**, Vivendi's Italian pay-TV business, and **Stream**, owned by News Corp. Vivendi is now seeking to pull out of the deal, leaving the loss-making Stream to its fate.

Mr Murdoch delivered a knock-out blow to **Kirch** by exercising early a *euro*1.7 billion ($1.5 billion) put option forcing Taurus, Kirch's holding company, to buy back BSkyB's 22% stake in KirchPayTV. The move should give the media magnate a say in proceedings when the cashless Taurus files for bankruptcy.

See article: European pay-TV operators in trouble

Alarm bells ring

The **Securities and Exchange Commission** widened its probe into dubious revenue-enhancing practices by American companies, going beyond the energy business. The investigations grew out of revelations that energy traders such as Enron, Dynegy, Reliant Resources and CMS Energy all engaged in illusory trades with each other so as to inflate reported revenues. The share prices of all the energy traders fell sharply. They stand accused also of contributing to California's electricity crisis last year.

See article: America's energy traders under investigation

Cable and Wireless woke up to the travails of its core web-hosting division, C&W Global. The company reported pre-tax losses of £4.7 billion ($6.7 billion) for the year, including a write-off of £4 billion on assets acquired during the telecoms boom. The company also announced a management reshuffle, with David Nash taking over from Sir Ralph Robins as chairman. Despite this, C&W's shares hit a 14-year low.

NNT, Japan's biggest telecoms company, announced Japan's biggest-ever corporate loss—¥812 billion ($6.49 billion) for the year. Heavy restructuring costs and huge losses on its stakes in overseas mobile-phone businesses were blamed: “an aberration” said the company.

Misrule by Fiat

Fiat's first-quarter losses hit *euro*529m ($464m), after a poor performance at its car-making arm. The Italian firm also announced an initial public offering of Ferrari, which would raise around *euro*750m, as part of its efforts to cut debt from *euro*6.6 billion to *euro*3 billion by the end of the year. More job cuts are said to be on the way.

Toyota unveiled record profits for the year, of ¥616 billion ($4.93 billion), 31% higher than a year ago, as overseas sales by the Japanese car maker boomed. Another Japanese car maker reported a more modest achievement. **Mitsubishi** made its first profit for three years—of ¥11.3 billion.

Sears Roebuck attempted a change of image with the acquisition of Lands' End, an online and catalogue

clothing company, for $1.9 billion. The big American retailer's fashion sense has often met criticism from investors and disdain from consumers. Buying Lands' End could beef up profits at a shop that is now more visited by buyers of appliances and power tools.

UBS and downs

USB, Switzerland's leading bank, announced that profits had fallen by 14% in the first quarter compared with a year ago, to SFr 1.4 billion ($870m), beating analysts' expectations. **Credit Suisse** made a profit of SFr368m in the quarter, down by 74% on a year ago, an improvement on two consecutive quarterly losses but still not up to analysts' forecasts.

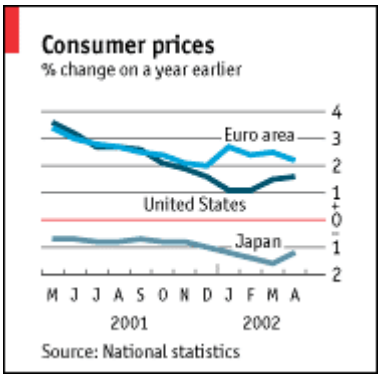
Zurich Financial Services, a once highly profitable Swiss insurer that has hit hard times, named a successor to Rolf Hüppi as chief executive. The task of returning Zurich to profitability falls to an American, James Schiro, a former boss of the accounting firm PricewaterhouseCoopers.

Underrated?

Japan responded angrily to threats by Moody's Investor Services to downgrade the country's credit rating again. Although it would retain an investment grade, worries over a burgeoning national debt, shrinking economy and plodding efforts at reform could spur Moody's to cut Japan's rating one notch, to the same level as Botswana, or two notches, to the same rating as Greece.

See article: Japan faces a rating downgrade

American consumers just keep on spending. Retail sales in April rose by 1.2% over March, the fastest pace for six months. However, inflation accompanied America's spending spree. Consumer prices rose by 0.5% in April, to a rate of 1.6% over the past 12 months.



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Russia and the West

To Russia for love

May 16th 2002
From The Economist print edition

Vladimir Putin has plans for Russia that can also benefit the West

Get article background

HISTORY is offering Russia a second chance. Next week President Vladimir Putin will welcome George Bush for a summit that will have as a centrepiece the first Russia-America arms-control treaty in a decade. Then Russia and the leaders of the transatlantic alliance will inaugurate a new NATO-Russia Council. A year ago, all of this would have seemed the pinnacle of possible achievement in an awkward relationship between Russia and the West. Yet these events may be no more than diplomatic footnotes in a much bigger history-shaping process that had begun before the September 11th terrorist assault on America, but has accelerated sharply since. After 70 years of blind-alley communism, and ten more of drift, Mr Putin is making a determined bid for Russia to end its self-estrangement and join the concert of developed, democratic countries alongside America and Europe.

The shift is already measurable in encouraging ways. Fears that America's withdrawal next month from the two countries' 1972 Anti-Ballistic Missile (ABM) treaty would produce another eyeball-to-eyeball confrontation have faded. Not many months ago, the deployment of large numbers of American troops to bases in Central Asia, and the despatch of military advisers to Georgia, would have been seen in Moscow as an intolerable incursion into Russia's jealously guarded geopolitical space. Instead Mr Putin is now sharing useful intelligence with America that has helped the war on terrorism, in Afghanistan and beyond. And while Russia's relations with NATO have often been openly hostile—to the alliance's plans to take in more recruits from Eastern Europe, and to its military intervention to end the bloodletting in the Balkans—by month's end the discussion will instead be of common problems, from counter-terrorism to peacekeeping, and efforts to tackle them together.

Winning Russia for democracy was supposed to have been the great prize at the end of the cold war. But hopes foundered on familiar rivalries and suspicions. Will that happen again? Plenty of Russian generals and diplomats of the cold-war school still see the “qualitatively new” relationship with America and Europe that Mr Putin is after as a sell-out at worst, and at best an indicator of Russia's own weakness and decline. There are westerners, too, who fret that Russia could once again all too easily turn from would-be friend to foe.

The measure of Russia

The sceptics are right in one respect: Russia is a lot weaker than it used to be. Mr Putin is in some ways trying to make the best of a bad job. He needs the arms-control deal announced this week more than Mr Bush because Russia cannot afford to maintain the arsenal it has (see article). He has piped down over NATO enlargement and the ABM treaty in part because he sees little point in picking fights he cannot hope to win. And he was probably all the happier to see America squashing the Taliban in Afghanistan, because Russia's cash-strapped army wasn't up to the job, and because America's arrival in Central Asia represents something of a counterweight to growing Chinese influence there.

Yet unlike his predecessors, Mr Putin is not satisfied merely with managing Russia's decline. He knows that the 21st-century measure of its influence will be economic growth, not its missile tally. His strategic goal is to get Russia into

Unlike his predecessors, Mr

the World Trade Organisation, not to keep tossing spanners into western works. He may still be more of a Russian liberaliser than a western-minded one, but he knows that Russia's economic future needs to be built on the difficult reforms needed to qualify for the world's premier trading club, not on the fickle price of its oil exports (see article). That is why America and Europe should resist the temptation to bend WTO rules to shoe-horn Russia in.

Putin is not satisfied merely with managing Russia's decline

Yet if Russia is to reform and eventually prosper, it will need two other things: a secure and stable neighbourhood, and new investment. This casts Mr Putin's recent policy shifts in a different light. Since the threats to Russia now come, not from America or NATO in the west, but from the south and the east, it makes sense to work with America and Europe to counter the problems of terrorism and weapons proliferation. America and Europe, moreover, are home to the firms and stockmarkets Russia needs to help finance its economic revival.

Helping himself

In other words, Mr Putin's is a pro-Russia policy, not a pro-western one, but there can be plenty of beneficial overlap. And from these shifts others can flow. It makes sense for Russia to keep on good terms with neighbouring China, but that country's hopes for a rejectionist front against America's missile-defence plans have fallen through—leading it, perhaps, to seek better relations with the Bush administration too. Russia itself is once more co-operating in the UN Security Council (after assurances that its commercial interests will not be overlooked) to get weapons inspectors back into Iraq.

Grumblers ask: What's in it for Russia?

Things will not always run this smoothly. Agreement to disagree more politely—as America and Russia are now doing over missile defences—though welcome, only goes so far. Part of the difficult new agenda at next week's summit will be Russia's determination to press ahead with nuclear assistance to Iran, despite concerns at that country's bomb-making ambitions. And while terrorist atrocities in Russia, such as last week's bomb in Dagestan, rightly invite western condemnation, so still should Russia's bloody campaign against separatists in Chechnya whenever human rights are trampled on.

Other differences are bound to emerge along the way. The popularity Mr Putin enjoys, and which he is relying on to continue what some Russians still see as his maverick foreign policy, may not endure once the painful changes needed for WTO entry start to bite. Grumblers ask: What's in it for Russia?

The answer is the sort of future Mr Putin is sketching out: an economically capable Russia; not the superpower it once was, but a power among others, respected for the contribution it can make, not feared and quarantined for the damage it can do. Such is Russia's opportunity. Will it grasp it?

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Sierra Leone

Soldiers of mercy

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Humanitarian interventions can work

AP

WHAT matters most about this week's election in Sierra Leone is not who wins, but the fact that it is being held at all. After a decade of civil war, in which at least 45,000 people died and many more were mutilated, this small West African country at last appears to be at peace. On May 14th, nearly 2m Sierra Leoneans lined up to vote (see article). Those whose hands had been chopped off during the war voted by stamping a big toe-print on the ballot paper.

The previous election, in 1996, was boycotted by the rebels of the Revolutionary United Front (RUF), who carried on fighting. This time, the omens are better. The RUF's leader, Foday Sankoh, is in jail, and most rebels have surrendered their guns. Bar a burst of stone-throwing, the polls have been calm. One presidential candidate has threatened to make the country ungovernable if he loses, but most people expect peace to hold.

If so, outsiders can claim much of the credit. Sierra Leone was tugged back from the brink of chaos two years ago, when British paratroops landed in Freetown, the capital, to stiffen a struggling UN peacekeeping force and prevent the RUF from seizing power. Once the city was secure, the Brits helped the state to start functioning again. A British civil servant took charge of the police force, and British officers are training the ill-disciplined Sierra Leonean army. The UN peacekeeping operation in Sierra Leone is now its largest anywhere.

Most people expect peace to hold. If so, outsiders can claim most of the credit

Should the success in Sierra Leone encourage those who think that western powers ought to try to rescue “failed states”? After September 11th, many people have argued that such interventions are in the West's own interest. When states collapse, they can become havens for terrorists and drug-smugglers, and prompt destabilising multitudes of refugees to head for richer countries. If possible, such problems should be avoided by preventing states from collapsing in the first place.

Sierra Leone, however, never really threatened the interests of the wider world. One out of five Sierra Leoneans did flee from home during the civil war, but most were far too poor to pay the air fare to Europe, so they sought refuge in neighbouring countries instead. Even at its most chaotic, Sierra Leone was never a breeding ground for terrorists with global reach. Nor was it a significant source of drugs. So the compelling reason to intervene was humanitarian. If there is a lesson to be learned, it is that it can be possible for western powers to use military force far from home for humanitarian purposes without sinking into a quagmire. In Sierra Leone a rabble of drugged-up teenagers with Kalashnikovs were terrorising an entire country. A relatively small force of professional soldiers was able to stop them in a matter of months.

The world should take note of this happy outcome. The appetite of the western powers for military altruism waxes and wanes, often depending on how the previous expedition fared. The debacle that followed America's well-intentioned joining of a UN intervention in Somalia in 1993 had a baneful effect on foreign policy for the rest of the decade. It was one reason for the West's failure to respond to the genocide in Rwanda the next year, in which some 800,000 people perished. Sierra Leone, admittedly, is a tiny place, easily reached by seaborne forces. Making peace in the remoteness of Congo, say, which is 33 times larger and the scene of fighting between five national armies and several rebel groups, would be much harder. But the fact that some jobs look too hard to take on has never been a good reason to

shirk the jobs that don't.

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After East Timor's independence

Indonesia minus

May 16th 2002
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East Timor is free at last. That need not lead to the disintegration of the rest of Indonesia

Get article background

ON MAY 20th, East Timor will become an independent country, after 450 years of unenlightened Portuguese rule, 24 of brutal Indonesian occupation, and two-and-a-half under the supervision of the UN (see article). Much of Indonesia's military and political establishment bitterly opposed allowing the half-island to go its own way in the late 1990s, for fear of a precedent that might unravel one of the world's most artificial countries. This opposition, in the case of some of the army's most senior officers, took the form of encouraging vicious militias to slaughter Timorese independence-seekers and destroy the island's pitiful infrastructure. That was plainly criminal. But was the underlying fear of unravelling justified?

Some countries are based on language, some on ethnicity, some on religion: Indonesia is based on the principle, odd in the mouths of nationalists, that whatever was administered as the Dutch East Indies in the 19th and early 20th centuries is now Indonesia. That is the justification it gave for annexing the western half of the island of New Guinea in 1963, even though its inhabitants are Melanesian not Malay, animists and Christians, not Muslims. Even by that standard, though, Indonesia's seizure in 1975 of East Timor, which the Dutch never owned, was unjustified. In that sense, therefore, East Timor's independence ought not to be a precedent for anything.

This has not prevented others in Indonesia from seizing on East Timor's freedom as encouragement for their own separatist movements. Since the UN moved in to East Timor in 1999, pieces of the Indonesian archipelago have at times seemed on the point of scattering apart like so many pearls of a snapped necklace. Separatist movements exist in Madura, Kalimantan and the Moluccas, though they are puny in comparison with the two best organised, in Aceh on the northern tip of Sumatra, and, at the other extremity, in West Papua (formerly called Irian Jaya, and before that West New Guinea) some 4,000km (2,500 miles) away to the east. One of the main reasons why President Abdurrahman Wahid was removed from office last year is that the powerful security forces had lost faith in his ability to hold the remainder of Indonesia together. In both Aceh and Irian, the separatists were becoming increasingly bold, and the methods used by the army to discourage them increasingly brutal. As ever, the brutality was counter-productive: it tended to feed the separatist case rather than quell the appetite for independence.

Rethreading the necklace

If Indonesia is to avoid the sort of bloody disintegration that tore apart Yugoslavia, its government must show more imagination. Rather against the odds, Indonesia's latest president, Megawati Sukarnoputri, appears to be doing so. In Aceh, at least, there are grounds for cautious optimism. The government has devised a formula under which it will allow the Acehnese to keep a much higher proportion of their oil wealth than they have ever been offered before. And a new round of peace talks under way in Geneva holds out the possibility of negotiating a ceasefire, with a political settlement to follow. Although “autonomy” is a word the Free Aceh Movement says it will never accept, this could yet be the outcome, if the Indonesians make the package more attractive. The negotiations in Geneva are taking place in the context of a programme of devolution that has already loosened Jakarta's iron grip on Indonesia's provinces. A breakthrough could end a war that has claimed 5,000 or more lives in the last decade, and

which neither side has seemed able to settle on the battlefield.

The outlook is bleaker in West Papua. There, Indonesia has hardly helped its cause by allowing its security forces to arrange the assassination of the principal Papuan leader, Theys Eluay. The government has at least edged closer to admitting the possibility that this crime took place, which is a start. Next there must be a proper investigation, followed by the trial of those responsible. Even then, keeping West Papua within Indonesia may, in the end, prove to be too difficult. For ethnic and religious reasons, of all Indonesia's far-flung possessions, West Papua has the strongest claim to eventual independence. But there is some reason to hope that, elsewhere at least, Indonesia has learned the right lessons from its bloody, and ultimately futile, attempt to bludgeon the people of East Timor into submission.

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Credit-rating agencies

Free the New York three

May 16th 2002
From The Economist print edition

The rating agencies should be taken out of financial regulation

RATING agencies have had a good run. For three decades they have acted as quasi-official regulators of public debt markets, and yet enjoyed the fat fees of financial intermediaries, all the while escaping the brunt of attacks on bankers, auditors and the rest of the financial industry. Now they are under scrutiny. The Securities and Exchange Commission is looking into whether the three agencies that it officially recognises (Moody's, Standard & Poor's and Fitch) really compete with each other, and whether barriers to new entrants need to be lowered. And it is investigating the payment of fees to rating agencies by issuers of debt, which seems like one more recipe for the conflicts of interest that so bedevil Wall Street.

The agencies have also moved into new and dangerous territory. They have examined, stress-tested and given ratings to some of the most exotic structured-finance instruments designed by investment bankers. Most of the time these ratings have been conservative, and have probably saved investors money and grief. But their ratings for one new instrument, collateralised debt obligations (CDOs), have not done so well (see article). In the past year these repackaged and rerated pools of debt, which should have enjoyed stable ratings because of their diversified nature, have suffered a sudden spate of downgrades. More seriously, the agencies have been lured into rating not just the instruments but the competence of the teams that actively manage these portfolios. This may take them beyond their own competence.

It also makes one wonder what precisely such credit ratings are for. Beyond simply assessing the odds of a company or a country not paying its debts, rating agencies are now being asked to second-guess, and ultimately to endorse, the performance of creative banking products. This may work for pools of assets, such as mortgages, the behaviour of which can be actuarially assessed. But rating agencies should surely not be involved as supervisors of fund managers, especially of unregulated hedge funds: they ought to be backstops, not gamblers' stooges.

Through no fault of the agencies themselves, ratings have also become a currency against which the market trades. Debt traders bet on corporate downgrades. Borrowers whose debt is downgraded may face sudden death as trigger clauses push up their cost of borrowing and their access to finance dries up. Perhaps the rating agencies are telling investors only what the markets already know. Yet the impact of a ratings downgrade can still be devastating.

Besides worries over conflicts of interest and competence, there are also concerns over the reliability of credit ratings. The agencies' record on sovereign debt is spotty: they largely missed East Asia's financial crisis, for instance. Japan's recent and prospective downgradings have been controversial (see article). As for corporate debt, even though the overall quality of the ratings may not be too bad, there have been plenty of examples of sudden, unexpected rating changes; and other cases (including Enron) when the agencies were unaccountably slow to downgrade. There are some signs from credit spreads that investors no longer believe all ratings.

Besides worries over conflicts of interest and competence, there are also concerns over the reliability of credit ratings

Despite this, the markets seem addicted to Moody's, S&P and Fitch ratings; and so, it seems, are the regulators that use them to limit what many funds can invest in. The new Basel bank-capital standards, due to be applied from 2006, will increase the addiction, because they propose to

give ratings a role in determining how much capital banks must hold. It would be better to find a way to break the addiction altogether.

Let 1,000 flowers bloom

To do that, new entrants and new types of rating need to be encouraged: no newcomer has been recognised for ten years. And less weight should be placed on the methodology and findings of the agencies, by both investors and regulators. The best way to achieve both aims is to take agencies out of the framework of financial regulation, and return them to their origins as mere servants and guides for the capital markets. The Basel negotiators should find other ways of harnessing the markets' judgment to their rules for bank capital. When ratings become not just a tool for investors but the very basis for regulation, they are likely to become distorted, and conflicts of interest risk becoming sharper.

Would taking credit ratings out of regulation leave investors unprotected? Hardly any more than now. There is always a risk that funds will be invested badly. Restricting the kinds of corporate or municipal bond that they buy does not stop many going into even riskier equities. Besides, higher risk is an inevitable counterpart of higher returns. It is better that investors learn that for themselves, rather than relying on regulators, or rating agencies, to protect them from their own folly.

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British constitution

Lords save us

May 16th 2002
From The Economist print edition

The argument over the House of Lords has started all over again. Elect the thing, for goodness sake

Get article background

PA

INTRODUCING the government's latest move on House of Lords reform, Robin Cook, leader of the House of Commons, described it as the next step in “the most substantial programme of constitutional reform for over a century”. That doesn't say a lot, given that most governments over the past century have regarded constitutional reform as first cousin to Bolshevism; nor do the reforms add up to anything like as much as Britons were led to hope. In a country where so much power is concentrated in the hands of the executive, checking that power must be one of the primary aims of constitutional reform. Yet the details of the government's reforms betray its determination not to reduce the power of the executive.

It's not been a good month for constitutional reform. A fortnight ago, the first elections outside London for elected mayors—one of the big ideas of Tony Blair's constitutional platform—were held. Most towns and cities had already rejected the idea of having mayors. Among the seven elected were a policeman suspended by his local force and a man in a monkey-suit. The lack of enthusiasm or seriousness with which the idea of mayors has been greeted probably has more to do with the electorate's understanding of the powerlessness of local government than with the apathy that politicians bemoan.

A week ago, the government published its plans for elected regional assemblies, which were welcomed with both yawns and derision. The assemblies' limited powers will be derived largely from those taken away from other tiers of local government. The centre certainly isn't giving up any real power to the regions. Nor, as the story of House of Lords reform suggests, is the executive planning to give any up to the legislature.

A hundred and thirty-five years ago, Walter Bagehot, a former editor of this newspaper, wrote: “a severe though not unfriendly critic of our institutions said that ‘the cure for admiring the House of Lords was to go and look at it.' ” Except that most of the hereditary peers have been replaced by party placemen, things haven't changed a lot since then.

The argument over reforming the House of Lords revolves around the question of whether all of it should be elected by voters, or none of it, or just part of it. The incendiary idea of a wholly elected house was rejected by the Royal Commission the government set up to look into the question—not, perhaps, surprising, given that the government chose as chairman Lord Wakeham, a Tory peer who was subsequently regarded as having done a fine job protecting the interests of newspapers at the Press Complaints Commission, a post he stepped down from as a result of his directorship of Enron. Anyway, the government embraced the good peer's recommendation of a largely appointed, largely powerless, House of Lords with enthusiasm, and last November it produced a White Paper suggesting that 20% of a reformed chamber should be elected, and the rest appointed.

Yes, there is an easy answer

Backbench Labour MPs, some of whom had naively believed that the government was serious about creating a second chamber with more legitimacy, and therefore more power, revolted. The cabinet split;

Mr Blair decided to dump the White Paper; and on May 13th it was announced that the matter would be handed over to a joint committee of both houses of Parliament.

The committee will no doubt spend a happy few years carving up the power and patronage between them, while rehearsing the old arguments. Will an elected Lords be dominated by political parties? (So what if it is?) Will we sacrifice the accumulated wisdom of the greybeards now in the Lords? (They can stand for election if they think they are so wise.) What shall we do about the Law Lords and the bishops? (Set up a Supreme Court and disestablish the Church of England.)

Setting aside the government's self-interest, the amount of time spent arguing about whether or not Britain's second chamber should be directly elected or not seems bizarre. Of course it should be. Direct elections are how democratic countries get their legislatures. Legislatures are reckoned to work better if they have second chambers. *Ergo*, Britain should have an elected second chamber. Hard, wasn't it?

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Letters

May 16th 2002
From The Economist print edition

The Economist, 25 St James's Street, London SW1A 1HG
FAX: 020 7839 2968 E-MAIL: letters@economist.com

Events in Venezuela

SIR – Two articles on events in Venezuela between April 11th and 13th are marred by inaccuracies and what some might characterise as a slur ("Tales from a failed coup", April 27th). America's message to all parties in Venezuela before and during the crisis was consistent, clear and forthright: firm rejection of any unconstitutional and undemocratic efforts to overturn the constitutional order. We did not ignore the suspension of the National Assembly by interim authorities but strongly urged its retention. Moreover, we worked closely with our hemispheric partners, before, during and after the events, to encourage a peaceful and democratic resolution to the crisis.

The most egregious element of your article is the intimation that the policy of the United States towards Latin America is distorted by the presence of "Cuban-American" officials at the National Security Council, Department of State and USAID. It is difficult to see why national background is any more relevant to good sense and sound policy judgment in the case of Cuban-Americans than in the case of other hyphenated Americans, who make up all of our population.

As for the references to the past of "most-controversial" Otto Reich, it is untrue that he was an adviser to the Nicaraguan Contras in the 1980s, or that he helped Oliver North raise money for them ("After the coup, the reckoning", April 20th). Mr Reich's job at the Department of State in the 1980s was to provide the American public with accurate information about events and American policy objectives in Central America.

It is true, however, that he was and remains a staunch anti-communist, just as you say. Mr Reich is proud of being an American of Cuban extraction and of having worked to remove the menace of communism from most of this hemisphere. This is a trait Cuban-Americans are proud of and one that demonstrates ample good sense and sound judgment, as recent world history bears out.

Charles Barclay
Spokesman and media adviser
Bureau of Western Hemisphere Affairs
US Department of State
Washington, DC

Advanced burgernomics

SIR – The Big Mac index provides an interesting take on currency valuation (Economics focus, April 27th). At the Asia Monitor Resource Centre (AMRC) we too use the Big Mac to highlight some interesting figures. Last month, we collected the prices of burgers from around the region and compared them with the wages of the people who clean McDonald's restaurants. Then we calculated how many hours an employee would need to work to buy a Big Mac.

In Australia, workers toiled for only about 20 minutes to earn enough to chow down. In Pakistan, however, cleaners work for over 14 hours for the same pleasure. India comes in second, where employees work for eight-and-a-half hours for one (McChicken) burger. In Sri Lanka they need nearly six hours, and in Hong Kong, just under an hour. Some currencies may look cheap against the dollar but for workers in much of Asia burgers look pretty expensive.

Stephen Frost
AMRC
Hong Kong

Europe's attitude to Jews

SIR – I read with ambivalence your leader discussing whether anti-Semitism might underlie the ferociously anti-Israel views of Europe's press and public generally ("Europe and the Jews", May 4th). You are right that to call someone an "anti-Semite" is considered a terrible thing almost anywhere in Western Europe. However, the anti-Semitism that is deplored is understood as an historic and overt hatred or disdain for Jews. Much of what is now written and said about Israel in Europe's media and in public discussion is more subtle, and though certainly not entirely the product of anti-Semitism, nevertheless carries something more than a whiff of it.

It appears that many Christian Europeans resent Jews for making them feel guilty about the Holocaust. Having had to endure the reproaches of Jews, or of their own conscience, they demand an impossibly high standard of behaviour from these same Jews, and are quick to find fault and condemn them harshly. Europe's recent sympathetic interest in Judaica is an interest in a largely vanished or much reduced people and culture. It is easier to reconcile with a dead people than a living one, especially when a branch, Israel, is bumptious, fractious, sometimes brilliant, sometimes stupid, sometimes confused and now led by a limited man who has shown himself capable of blundering brutality toward his country's enemies.

Finally, Christian Europe carries guilt for its colonialist past, and equally, for its present maltreatment of Arab and other ex-colonial immigrants. How easy it is to expiate that guilt vicariously, by demonising Israel for its treatment of the Palestinians rather than to make amends to the victims of its own racism and xenophobia.

Stuart Kaufman
San Francisco

Sicilian defence

SIR – There are problems in Sicily that slow down its economy's recovery, but your article does not truly reflect the situation ("The EU's third-world island", May 4th). People in Sicily are showing a terrific strength in reinventing themselves and demanding a new international role. They no longer want to be regarded as "mafiosi"; they want to be known for their efforts in looking for a better future. Unfortunately, the constraints of Italian politics and structural limits are slowing down Sicily's full recovery. Besides, even in the third world there is often something from which to learn.

Massimo Felici
Edinburgh

SIR – Your article about Sicily's poor infrastructure was spot-on. Just a couple of days after the article appeared, hotels in the centre of Palermo suffered a water crisis, with no supply for more than an hour. On one recent Sunday, we had running water for just half an hour. When I rang the local water utility to complain, it insisted that the water had been flowing freely. It is a small wonder that a great many Sicilian companies prefer to buy their water from private dealers.

Maurizio Bonura
Palermo

Felix qui nihil debet

SIR – You mention that banks issue credit cards to people with no job or bank account ("Debtors' bail", May 4th). In my experience, they even issue pre-approved cards to people who do not exist. I subscribe to publications using different first names, to track who sells their list to whom. My subscription for *The Economist* comes to "Felix" Pelletier, who sounds good and smart. "Ingemar" Pelletier gets ski mags, "Bud" Pelletier visits beer-related websites, etc. They have no jobs or bank accounts as they do not exist. Yet in Felix's post bag every year are several pre-approved credit-card applications, with $50,000 being the highest credit offered thus far. So if Felix takes up the offer of the card, he could buy Ingemar some new snowboards and Bud a pint or two.

“Felix” Pelletier
Toronto

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What Russia wants

Vladimir Putin's long, hard haul

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From The Economist print edition

Relations between Russia and the West have rarely been better. But what does it mean in practice? And can it last?

Get article background

FOR more than ten years, Russia's relations with the advanced countries of the western world have been a torrid and unsatisfying mixture of unrequited love, misunderstanding, dashed hopes, sulks and tantrums. As President Vladimir Putin prepares to meet George Bush next week in St Petersburg, things are looking both calmer and more hopeful.

There have been big shifts on both sides. The West is no longer trying to recast Russia in its own image. The days are gone when politicians in Washington used the International Monetary Fund as a foreign-policy slush fund to promote particular policies and politicians in Russia. These days, Russia runs itself more or less as it likes. The result is a semi-authoritarian country, still corrupt though perhaps less so than it was a few years ago, and much more politically stable.

Economic growth is slow but encouraging: Russia registered its third consecutive year of real growth in 2001, with GDP up by 5%, and at a time when the world's big economies were sluggish. Although good official connections in business still matter hugely, the days of central planning are gone for good, as is the wild era of looting and barter that followed the collapse of communism. Russia delivers its oil and gas on time and, to general surprise, is steadily paying off its foreign debts. Compared with what might have happened, the outside world finds that cheering.

Russia now has a more realistic sense of its own weakness

Russians in business and politics alike used to see foreigners either as a threat or as gullible outsiders fit only for milking. Now expectations are more sensible. Russia has a more realistic sense of its own weakness: that it is a global superpower thanks only to its vastness, and in the narrow sense of its decaying stock of all-but-unusable nuclear warheads. In every other respect, it is at best a medium-sized power. Its economy is barely larger than Switzerland's, its population around the same as Pakistan's. Russia needs good relations with the outside world to stand even a chance of gaining the investment and know-how necessary to catch up.

No one at the top in Russia sees this more clearly than the impatient Mr Putin, who since September 11th has moved sharply to portray Russia as an amenable partner for the West. If sustained, this will be a huge change. The biggest difference this has made so far is to reverse some policies that have proved

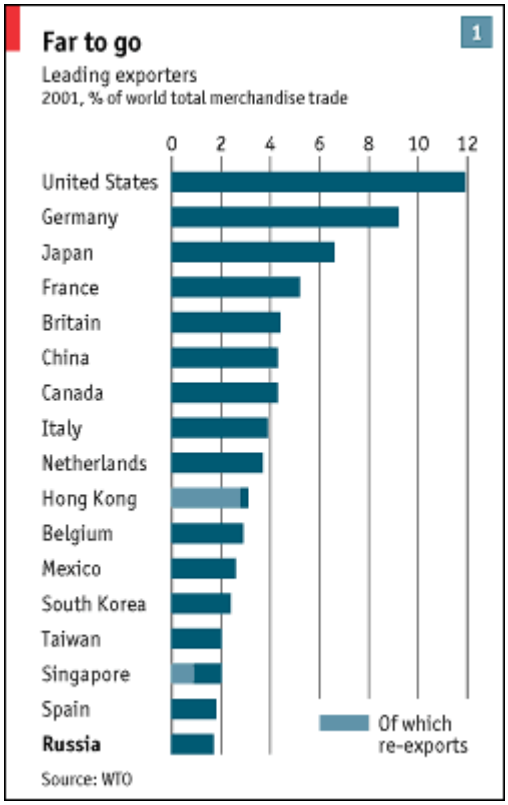
ineffective in the past. Instead of sulking over the expansion of NATO to former Soviet allies in Eastern Europe, Russia is building a new relationship with the alliance. Instead of regarding Central Asia as its own backyard, it is accepting a big, and maybe stabilising, western military presence there. It is accepting, from a position of weakness, a deal with America on nuclear weapons—sensibly, given that it can barely afford to keep the ones it has—and Mr Putin decided not to make a fuss about America's intention to build missile defences. There are signs of a shift in Russia's dogged support for Saddam Hussein, and in its over-cosy nuclear relationship with Iran.

Stopping bad habits is one thing. Starting good new ones is harder. The main positive shift has been in intelligence-sharing, especially in counter-terrorism, although even here the Russian side complains that the West has provided little in exchange, and old games such as snooping on military technology continue. Elsewhere, practical co-operation is still limited. Hawks on both sides, but particularly in Russia, are unwilling to give up their old thinking.

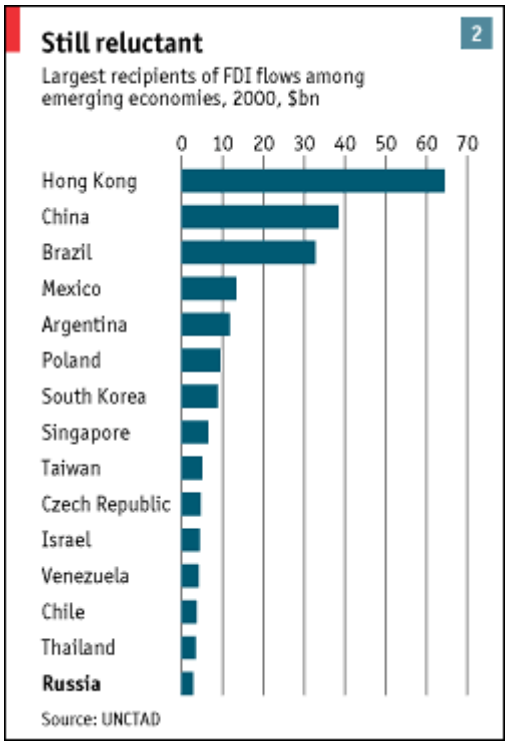
Sidling towards integration

As the summit nears, so the questions accumulate. What do the new relations mean in practice? How easy will it be to fit Russia into the rich world? Are the changes sustainable? Can Mr Putin manage to drag his country single-handedly towards the West? If he faces failure, how will he retreat? And what happens if he goes?

Economic integration is the most important plank of Mr Putin's new policy. Russia's share of global trade is pitiful (see chart 1), given the country's history and level of education. Russia's manufactured exports still amount to little more than guns and vodka. Excluding oil, gas and metals, those bits of Russian industry that do sell abroad (steel and bulk chemicals, for example) rely on artificially low energy prices. Russia still carries a large burden of debt, about $143 billion; Mr Putin would like the Americans and Europeans to write off a further chunk of this, but they are not eager to do so. The economy, after all, is growing, though much of this is because of high oil prices and the effects of a 75% devaluation of the rouble after the financial crash of 1998, rather than to the growth of competitive, well-managed businesses.



Changing that is going to be a long, hard haul. There are promising signs, however. Private home-grown business has put down solid roots in the past ten years. More foreign companies are starting to manufacture goods in Russia or to set up basic consumer industries such as food production. As chart 2 shows, foreign investment flows into Russia have been tiny. But western skills in quality control, distribution, marketing and branding still make a huge difference, especially when local competition is weak and imports are kept out by tariff barriers and bureaucracy.



Foreigners are also investing in industries that offer better long-term prospects. Sandvik, a Swedish engineering company, says its factory in Moscow produces higher-quality goods than its British one, though productivity still lags. A few years ago it was hard to find any foreign company manufacturing in Russia for the world market. Now

there are several.

The biggest deterrent to business of all kinds, foreign or local, is Russia's corrupt and inefficient bureaucracy. This raises the cost of doing business, in bribes or paperwork. It can also threaten a firm's survival. Get on the wrong side of some powerful local clan, and you may find your factory stormed by bailiffs, armed with a court order saying that you no longer own it. This happens less than it once did, but still too often for comfort. Russia has made progress in building a law-based system, instituting jury trials and paying judges a bit better. But, as Mr Putin himself admits, there is a long way to go.

A huge step would be for Russia to join the WTO, but there are many issues to settle first

A huge step would be for Russia to join the World Trade Organisation (WTO), the body that sets and polices the rules for international trade. On paper, this would do much to make Russia a more predictable place to do business. But there are dozens of issues to settle first. Uncompetitive Russian banks, insurance companies and car makers, not to mention the country's notoriously inefficient farmers, want lengthy periods of protection against real competition. Then there is the huge hidden subsidy of cheap energy, which boosts swathes of the Russian economy but infuriates foreign companies making fertiliser, steel and so forth. The lethargic and arbitrary customs system has defied all serious reform attempts so far. Optimists think WTO membership will finally sort that out, too. So far, Russia has proved quite good at passing laws but much less good at implementing them. Membership of the WTO seems certain—after all, China eventually managed it—but probably not before the middle of the decade.

Chiefly, though, WTO membership will give more recourse to the wronged rather than prevent abuses happening. More substantial progress may take a generation. So long as the rich and powerful are mostly above the law, businessmen of all stripes will take a lot of convincing before they put big money into Russia.

Rethinking geopolitics

Russia also needs to fit in politically. Compared with the isolation of the Soviet era, Russia's integration into international bodies has been stunningly successful. In talking shops such as the Organisation for Security and Co-operation in Europe and the Council of Europe, a sort of ante-chamber to the European Union, Russia is an established member. Its helps with peacekeeping in Bosnia, as well as with peacemaking in the Middle East.

But there is still a long way to go. Take Belarus, about the last truly autocratic regime left in Europe, and Russia's closest Slavic ally. The country's western neighbours speak out regularly on Belarus's rigged elections, harassment of journalists and members of the opposition, and other chicanery. But Russia is silent. Despite Mr Putin's visible distaste for Alexander Lukashenka, his mercurial and eccentric Belarussian counterpart, Russia endorsed the rigged elections that returned him to office last year.

Old geopolitical thinking also dies hard in poor Moldova, a former Soviet republic that abuts Romania. Along Moldova's northern border, a highly criminalised Russian-backed separatist regime still rules a tin-pot republic called Transdniestria. Old attitudes still affect relations with the Caucasus, where the Kremlin's client regimes in forgotten places like Abkhazia and South Ossetia maintain their miserable misrule. Russia has been playing a more constructive role of late in trying to solve the decade-old frozen war between Armenia and Azerbaijan, but could do much more. Russia is also obstinately refusing to normalise relations with its former Baltic satellites, Estonia, Latvia and Lithuania, which are now close to joining the EU and, most probably, NATO too.

The most pressing practical issue is the Kaliningrad region, a Baltic exclave of Russian territory acquired only in 1945 and sandwiched between Poland and Lithuania. It is impoverished, disease-ridden and a prime business location for smugglers and other criminals. Russia accepts in principle the need to negotiate a special deal for the time when both Kaliningrad's neighbours join the EU. But it fears that Kaliningrad may break away, and wants no exemptions from the Schengen border controls to be allowed to Kaliningrad that are not also offered to Russia itself.

Russia is still miles away from western standards on

Most strikingly, Russia is still miles away from western standards on Chechnya, where ghastly cases of murder, torture and abduction of civilians at the hands of the miserably paid and led Russian soldiery are everyday events. Although the Kremlin position has softened a little from the first year of the war, no political solution is in sight. Although last week's bomb in neighbouring

Dagestan, which killed more than 30 and maimed dozens, has been blamed on a local warlord, Russians immediately blamed the Chechens: a reminder that the repeated claims of victory in the conflict are still premature.

Chechnya

Since September 11th, Russian propaganda has focused on the connections between the Chechens' resistance and international Islamic terrorism. Western criticism, never very vocal, has softened a little. In March, however, the American State Department's annual report on human rights included harsh criticism of Russian behaviour in Chechnya. Now there is a new irritant: Chechen-language broadcasts on Radio Liberty, which is financed by the United States. Some Russian politicians have demanded the cancellation of the station's broadcasting licence, used for locally based transmitters of the much more widely listened to Russian service.

Other western allies, such as Turkey, have plenty of blots on their human-rights record too. But Russia does not want to be another Turkey. Even if full EU membership is a very long way off, Russians want a serious, close and settled relationship with Brussels. But it is hard to see those ties becoming really chummy without some energetic tidying up of the various post-imperial loose ends. And of that there is still little sign.

Putin almost alone

On acute issues, such as American involvement in the former Soviet empire, Mr Putin is shunting Russia's policy in the right direction, towards accepting the inevitable. The next moves—developing good ideas and carrying them out—will be very much harder for him to make, since almost all the Russians involved, in the foreign-policy and defence establishments, either do not understand the new stance or disagree with it vehemently.

The president has allies in the new business elite, especially those members of it who have global ambitions. Democratic-minded Russians are increasingly impressed with his vocal criticism of the country's bossy, corrupt officialdom—although the president's close ties with the security services, his squeeze on the independent media and the misery in Chechnya mean that most liberals are still broadly sceptical rather than supportive. And almost none of these supporters is in a position to keep the new policy on track.

Yet this weakness seems unlikely to cause problems for Mr Putin at home in the immediate future. There is neither a convincing alternative policy, nor anyone to articulate it if it existed. Russia is too weak to challenge the West. The only powerful potential ally is China, a country which influential Russians see as a much bigger threat than America. Some top Russians like to suppose, as the Soviet Union once did, that America and Europe will eventually fall out, in which case Russia can team up with the Europeans. At the moment, that seems little more than wishful thinking. So does another fashionable bit of thumbsucking: the notion that America and Russia might team up, leaving the European Union behind. The only real choice is between the sulks, and making the best of it.

Furthermore, the political stage features no opposition leader worthy of the name. Even if popular discontent reinvigorated the Communist Party, which is now in outright opposition to Mr Putin, it is very hard to imagine it making a real bid for power. The Communist leader, Gennady Zyuganov, is unimpressive. The Kremlin has huge resources available for propaganda and election-rigging. That helped even the sickly, drunken, and highly unpopular Mr Yeltsin beat Mr Zyuganov in 1996. Mr Putin would find it much easier.

The political stage features no opposition leader worthy of the name

The president might fall out with the mighty clans who put him in power. But they are a lot less powerful now. The possible challengers from inside the political and economic elite are the prime minister, Mikhail Kasyanov, or Russia's electricity boss, Anatoly Chubais. So far, they have been loyal to Mr Putin. But even if they were able to force his resignation or topple him by some other means, there would be little change in foreign policy.

Public discontent also looks unlikely to upset things. Opinion polls show that around three-quarters of Russians distrust America or see it as an enemy. Yet Russians who can afford to do so consume western products and visit western countries for holidays, study or business. Most would like their country to become more “western”', meaning freer and more prosperous. If Mr Putin and his team become unpopular, it will be because of low living standards and dismal public services rather than discontent with, say, the architecture of the new NATO-Russia relationship or a long-term American presence in

Kirgyzstan. So long as integration with the world economy produces some powerful winners as well as losers, political support for it looks assured.

In the longer term, the future of Russia's pro-western policy depends on whether Mr Putin is able to stop the country's decline. High oil prices, and relief at the stability Mr Putin's rule has brought, have masked other unsolved problems, such as a demographic collapse (with the population shrinking by around 750,000 a year), an AIDS explosion (highlighted in a new World Bank study this week), crumbling infrastructure and ethnic and regional tensions. Continued decline would lead eventually to another economic and political crisis some time in the next decade. But that prospect looks distant now.

Two steps forward, two steps back

The real danger is not that Russia's march to the West goes into reverse, but that it bogs down for lack of ideas and people. If Russia is unable to come up with a good idea for joint action against Saddam Hussein, for example, America will go ahead and do what it wants anyway. Russia may get a generous serving of the post-Saddam oil and reconstruction contracts as a reward for keeping quiet—or America may decide that other, more useful, friends deserve a bigger share.

The argument in Washington seems to be between those who regard Russia as too weak to matter and those who think that there are big benefits to be won from co-operation and respect. So far the latter have been winning, for example in agreeing to Russia's request for the nuclear-weapons cuts agreed this week (see article) to be backed by a legal document rather than a mere political declaration. But that could change quickly if Russia cannot keep up.

Much detailed work is needed on the steps that would admit Russia fully to the civilised and developed world. One is WTO membership, but without any bending of the rules. Another is the sorting out of Russia's relations with its former empire, both inside the former Soviet frontier and beyond. Third, Russia needs to get to grips with the European Union, starting now to adjust its laws and habits to allow people, capital and goods to flow easily across the frontiers in both directions.

Most of all, Russia needs to change at home. A bureaucracy that stifles business and bullies its citizens is as bad for Russia's relations with the outside world as it is for Russians themselves. Russia must not allow this to obstruct the fact that it has many things in common with the West already, and their number is growing.

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Missiles and summitry

A farewell to armaments

May 16th 2002
From The Economist print edition

AP

But there's more to it than that

Get article background

WHEN George Bush shakes Vladimir Putin's hand next week in the Kremlin, after they have formally signed their new arms-cutting treaty, the two presidents will be standing for their photo-call in a place that for decades was routinely targeted by American missiles. Their two signatures, however, are a better sign of their commitment to “liquidate the legacy of the cold war”, as Mr Bush described their treaty-making this week.

Indeed, it seems that the American president cannot move fast enough to bring the cold-war past to a close. Last November, at his Texas summit with Mr Putin, he proposed that deals could be sealed with handshakes, rather than a formal treaty. This week he announced that the two sides had agreed to cut their strategic nuclear arsenals to no more than 2,200 warheads (around a third of the current total) in an almost off-hand remark as he headed for his helicopter. The Russians seemed to be left scrambling.

To some the confusion is a metaphor for the “new era” in relations that the Bush administration says all this represents. In fact, it is more businesslike than that. Mr Bush wants to get this “old agenda” stuff (as missile treaties are now seen) out of the way before the summit opens on May 23rd, so that in Moscow and St Petersburg the watching world can focus on “a new agenda” of co-operation between America and Russia.

The core of this new agenda will be contained in a political declaration to be made at the summit. It is expected to reassure the Russians that America's developing missile defences will not undermine Russia's nuclear deterrent. It will also map out new areas of common concern, from the war on terrorism and the combating of proliferation to deeper co-operation in making safe stocks of nuclear, chemical and biological arms—and the integration of Russia into the global economy.

The same new agenda was also behind the American-led decision to set up a new NATO-Russia council. That too will be formally unveiled at a second choreographed summit, in Rome on May 28th. But is there enough in the diplomatic works to turn all this tone into substance? And is the old agenda really so easily dispatched?

On arms control, the deal is another step forward; but hardly a conclusive leap. Russia had made no

bones about its wish to have a different sort of arms-control treaty: one that would lock America and Russia into the sort of detailed, step-by-step mutual arms cuts exemplified by the earlier Start-1 and Start-2 agreements and make them, in Mr Putin's term, “irreversible”. America wanted more flexibility.

The reduced warhead totals that must be reached by 2012 have been set down in legally binding form, as Mr Putin wanted. But the two sides will be free to mix and match their arsenals, subject to the rules agreed under Start-1 for checking that their promised cuts are made. Any warheads not fitted on operational missiles (ICBMs), submarines (SLBMs) or aircraft will not count towards the totals, and can be held in reserve, in case either side wishes to build up its forces again to meet new threats (see table). What is more, either side can give only 90 days' (instead of six months') notice of withdrawal.

These substantial get-outs will be another disappointment to those who wanted the warheads on both sides reduced to hundreds, not thousands. The deal is also less innovative than Bush administration officials are claiming. The process was little different from that which produced the Start-2 treaty back in 1993: several months of negotiation, summarised in a few short pages, with the whole deal relying on the hundreds of pages of detailed verification rules first set out in Start-1 in 1991.

Caging the eagle and the bear

US and Russian warhead deployments

	US forces		Russian forces	
	2002	2012	2002	2012
ICBMs	1,700	500	3,364	230*
SLBMs	2,784	1,440	1,868	616
Bombers	1,660	260	582	240
Total	6,144	2,200	5,814	1,086

*Depending on warhead load per missile

Source: Rose Gottemoeller, Carnegie Endowment for International Peace

The new deal also shows how much things have changed. Start-2, though ratified by the Senate and eventually by the Duma, has never been implemented. Had it been, it would have banned multiple-warhead missiles, which were then considered a devastatingly destabilising sort of weapon. Now Mr Bush's people have indicated that they will turn a blind eye to any plan by the Russians to mount triple rather than single warheads on some of their missiles—which would be a relatively cheap way for Russia to overwhelm future American missile defences.

Given the amount of flexibility, a lot depends on two things: how many weapons the two sides actually destroy, and how open they are about what they do. Condoleezza Rice, Mr Bush's national security adviser, says that America will dismantle some surplus warheads, rather than put them all in storage. Talks will also continue on new, more far-reaching ways to keep everything transparent. Rose Gottemoeller, of the Carnegie Endowment for International Peace, argues that the experts sent away to work on this issue must be formally required to report back to the two presidents at their next summit. Otherwise, people who want to resist such openness, particularly in Russia, might quietly kill this initiative.

A lot depends on two things: how many weapons the two sides actually destroy, and how open they are about what they do

Underneath all this, though, the signs are more positive. Since Russia is not the enemy, admits the White House, America no longer needs to fix the size of its future nuclear force against a target list in Russia. The threats it now must deter are smaller, if less geographically predictable, and will require not just nuclear deterrence but also better intelligence and smarter conventional weapons to defeat them.

Even without a treaty, America would have been reducing its arsenal to the same levels anyway, but unilaterally. But doing it together with Russia helps build trust. This may not necessarily be the last arms-control agreement between America and Russia, says one senior official—but with luck this will be the last summit at which arms control features as a central issue. And, indeed, the Russians too are already turning their minds to the newer agenda.

Agreement on the new NATO-Russia council is a measure of that. In the past Russia has sought a veto over NATO activities in order to block the alliance's enlargement (the next round will take place in November) or restrain its peacekeepers in the Balkans. Those are still sensitive issues, but here, as with arms control, transparency and confidence-building are what really matter. The new council will aim to work towards joint decisions on issues of common concern, from search-and-rescue missions to counter-terrorism and regional peacekeeping. Russia will have no veto, but the hope is that, as trust builds up, the agenda for co-operation can expand.

For Mr Bush, this is ground for hope. But the real winner is Mr Putin. He may not have got everything he wants from his new friend George, but with fewer nuclear weapons to worry about, and more to talk about with America and its close allies, Mr Putin can welcome Mr Bush next week with one of his broadest grins.

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The military revolution

Crusaders belong to the past

May 16th 2002
From The Economist print edition

Donald Rumsfeld goes for the future

THERE is an adage among Pentagon-watchers to the effect that, once a weapons programme has its name inscribed on a commemorative coffee mug, it becomes impossible to kill. Given a constituency of enthusiastic generals, job-conscious legislators and contractors big and small, it becomes untouchable. Dick Cheney, as defence secretary in the first Bush administration, learned the truth of this when he failed to kill the V-22 tilt-rotor aircraft, a pet project of the Marines.

His successor, Donald Rumsfeld, is now putting the coffee-mug axiom to the test. Not a moment too soon, say those who advocate a faster transformation of America's arsenal: less spending on heavy armour, and more on the smart electronics that enable commanders to “see deep and shoot deep” with flick-of-the-eye rapidity.

Mr Rumsfeld's 2003 budget, unveiled in February, pleased almost everybody in the defence world by virtue of its vast size, and drew cautious cheers from the transformers by promising more money for unmanned aerial vehicles. But they were disappointed by his insistence on ploughing ahead with virtually all the weapons the previous administration had dreamed up. This caution seemed a sign that, despite the president's vow to “skip a generation” of weapons, Mr Rumsfeld had lost his battle with the old guard.

Now comes a dramatic change. He has decided to kill the Crusader, a mobile artillery piece expected to cost $11 billion (of which $2 billion has been spent already), before its deployment in 2008. The gun's backers include some of the most senior Republicans in both the House and the Senate (especially the ones from Oklahoma, where it would be built); lobby groups such as the Association of the United States Army, which speaks for hundreds of thousands of soldiers and ex-soldiers; and the gun-maker's owner, the Carlyle Group, a private-equity firm which has had some big political names, including George Bush senior, on its payroll.

There will be a fight. Already the House has put money for the Crusader back into the 2003 budget; the Senate may do likewise next week. But President Bush threatens to veto any bill that includes cash for the gun. Prepare for a thunderous battle.

Opponents of the Crusader say the army should be concentrating on truly “transformational” projects like the Future Combat System—a mixture of unmanned and manned vehicles, weighing no more than 20 tonnes each, with as much firepower as old tanks that are four times heavier. The Crusader has been slimmed down from 90 tonnes to 40, but would still require a very big aircraft to carry it.

Until a few weeks ago, Pentagon officials were cheering loyally for the Crusader at hearings on Capitol Hill; you could put one on the Washington Beltway, they said, and fire a shell with perfect accuracy on to the Camden Yards baseball ground near Baltimore harbour. Even more pressing military tasks, such as silencing North Korea's or Iraq's artillery, might also be undertaken by the Crusader. But, reply the sceptics, there are ever-deadlier long-range rockets, aircraft and helicopters which could do the job even better.

Nobody suggests that axing the Crusader would, in itself, guarantee victory for those who want America's armed forces to make a quicker leap forward. But the reverse almost certainly applies. “If they lose this battle, they will definitely lose the battle for transformation,” says Steve Kosiak of the Centre for Strategic and Budgetary Assessments, a Washington think-tank.

Why, half-way through his second year in office, has Mr Rumsfeld suddenly decided to go into battle on a

front where, until recently, he seemed to be resigned to making tactical concessions? Maybe his vision of the Pentagon's future arsenal has undergone a dramatic change. Or maybe the cost of the war in Afghanistan, at $19 billion and rising, is requiring his department to make harder choices.

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Trade policy

Anatomy of a rotten deal

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Who thought that steel tariffs and farm subsidies could buy a fast-track bill?

EVEN by the tortured standards of Washington lawmaking, George Bush's struggle to secure trade promotion authority from Congress seems increasingly Sisyphean. Well over a year ago, Mr Bush announced that winning TPA—whereby Congress agrees to give up the right to amend any trade deals—was one of his top legislative priorities. Without such "fast-track" authority it is hard for any American administration to negotiate good multilateral trade deals. Though five previous presidents obtained this authority from Congress, it lapsed in 1994 and Bill Clinton never won it back.

In December 2001 Mr Bush looked set to do just that. Fast-track squeaked through the House of Representatives (traditionally the more protectionist chamber of Congress) by one vote. Getting TPA through involved several ugly compromises, especially on textiles and citrus fruit. But conventional wisdom held that the price was worth paying, partly because the Senate would be so much simpler to pass.

Alas not. Despite numerous protectionist sops to placate senators with special interests, including tariffs on Canadian lumber as well as the infamous steel tariffs, the Bush team is far from victory. Though Tom Daschle, the Democratic Senate Majority leader, claims he is in favour of free trade, he has been loth to hand Mr Bush a big election-year triumph without extracting a political price.

On May 9th, after weeks of wrangling, Mr Daschle got what he wanted: a trebling of trade adjustment assistance from $400m to $1.2 billion annually. The government will now help more workers whose jobs have been displaced by trade, and help them for longer. The provisions include a 70% government subsidy to help workers pay for continued health-care cover as well as a pilot scheme of wage insurance. Under this scheme the federal government would pay older workers who move to new, lower paying, jobs up to $5,000 of the difference between their old and new wages.

For Democrats, the trade-assistance agreement was a landmark, introducing several innovative ways to deal with the social consequences of freer trade. Many Republicans bickered that it introduced dangerous new entitlements. But the battle over fast-track seemed to have ended, not least because leading senators on both sides teamed up to fight off any amendments to their agreement.

Wrong again. Within days of the agreement the trade deal faced a slew of amendments, the most serious being one that excludes any changes to America's trade-remedy laws from the fast-track protection. Despite extensive lobbying and a veto threat from the White House, the Senate passed that amendment on May 14th. The Bush team was furious, pointing out that this "killer" amendment in effect emasculated the entire fast-track bill. Robert Zoellick, Mr Bush's top trade negotiator, blasted the amendment as "protectionism under a procedural cover" and claimed it would "cripple America's ability" to negotiate trade deals.

He is right. America has often misused its trade-remedy laws, especially its anti-dumping provisions—to the fury of its allies. A review of such trade rules is on the agenda for the new Doha round of global trade talks. (Indeed, the new trade round would almost certainly never have been launched if Mr Zoellick had not agreed to put trade rules on the agenda.) If American negotiators are unable to address trade rules, the round will almost certainly fail.

The Bush team now hopes this "killer" amendment can be excised from the final fast-track legislation that will emerge after negotiations to reconcile the Senate bill (once it is passed) with the House version. Since senior House Republicans and many leading senators oppose the trade-rules amendment, dropping the amendment, or at least watering it down, is a possibility, though it enjoys Mr Daschle's support.

Yet even if that snare is avoided, fast-track will not be won. The final compromise bill must be passed again by both the House and the Senate. Since at least two House Republicans who voted in favour of fast-track in December say they will now vote against, its passage is far from guaranteed. At the least, yet more back-door protectionist compromises are likely before Mr Bush gets his prize. He could end up with no fast-track at all, or a fast-track so weak it is not worth having.

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Comics in the movies

Heropolis

May 16th 2002
From The Economist print edition

Superheroes don't commute

FORGET this weekend's release of “Star Wars: Part I've-Forgotten-the-Number”. The hot ticket of the moment is “Spider-Man”. The reason why is clear. Millions of Americans are flocking to see its subtle analysis of urban sociology.

All right, maybe not. But it is true—or at least arguable—that “Spider-Man” is just the most recent example of the history of the American city reflected through the figure of a comic-book superhero in films. “Spider-Man” is set in New York—the archetypal city. It looks radiant. The skyscrapers gleam. The skyline is vertiginous and thrilling. Young love is in the air. There is, of course, a villain, but the New Yorkers in the movie spend their time refusing to be terrified by him. This is the post-Giuliani, cleaned-up New York of the 1990s.

Compare the previous superhero to get the Hollywood treatment: Tim Burton's “Batman” (1989). There the city was dark and threatening. Criminals lived in the sewers. The caped crusader had a lot in common with the crooks. This was the crime-ridden, pre-Giuliani Gotham. Skip back another decade to “Superman” (1978) and we are again in the optimistic city—at the end of the great post-war urban boom. In spirit, the film nostalgically reached back to the highpoint of that era—the 1950s and early 1960s world of Superman's slogan, “Truth, Justice and the American Way.”

The connection between comics and cities goes back to the very start of the artform. The first comic strip, “The Yellow Kid”, which ran in Joseph Pulitzer's newspaper, the *New York World*, in 1895, was about life in the city's tenement blocks. It might be unwise for urban planners to toss aside population figures and office-space vacancies as indicators of a city's health, though there does seem to be a link with the comics. But what next? The urban planners now think the future lies in sprawling suburbs and satellite cities. But no superhero has ever come from suburbia.

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California's budget

Mind the gap, Gray

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From The Economist print edition

The golden state is still reeling from the electricity crisis and the Internet bust. But its deeper problems date back to the 1970s

AP

If only his sums would add up

CALIFORNIA is required by its constitution to balance its budget every year. Seldom has this looked so difficult. After five fat years, in which the state's income swelled with its booming economy, the power crisis and the dotcom collapse have clobbered California—and Gray Davis, the once bounteous governor, has had to recut his coat accordingly.

Back in January, Mr Davis, who is running for re-election this year, envisaged a shortfall of $12.5 billion in the fiscal year beginning on July 1st. On May 14th he increased that figure to $23.6 billion—almost a third of the entire state general fund from which most expenditure comes. California's deficit now counts for almost 60% of the total deficit of all the country's 50 states combined.

Mr Davis's budget plan balances spending cuts with tax increases, borrowing and financial manipulation. As the most politically painful part, the tax increases bring in only $2.1 billion (mainly through reinstating higher licence fees on cars, and adding an extra 50 cents to each packet of cigarettes). Some $7.6 billion comes from cuts in spending programmes, mainly health and welfare. The remaining $13.9 billion is made up of an amalgam of more politically palatable borrowing and restructuring. An opportunistic $4.5 billion comes from securitising a portion of the pay-out of $25 billion spread over 25 years that California won from the tobacco settlement in 1998.

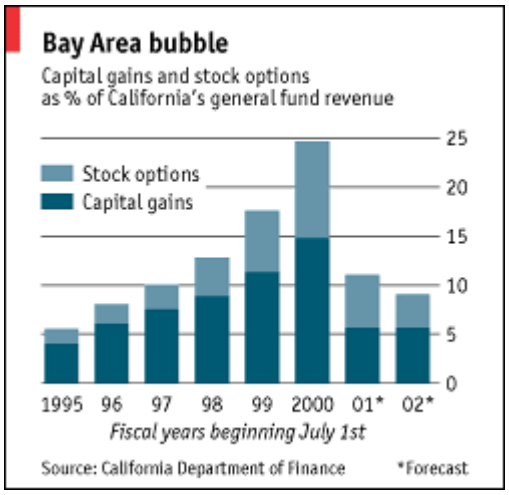
Inevitably, wishful thinking abounds. For instance, Mr Davis barely explains in his report why he should get $1.1 billion in extra federal funding (why should George Bush bail out a potential Democrat presidential candidate?). And Wall Street, which recently downgraded California's debt rating, may not lap up its bonds in quite the way that Mr Davis hopes.

The shortfall is commonly blamed on the dotcom recession and the electricity crisis. Mr Davis has found a convenient scapegoat for the budget mess in Enron: he argues that out-of-state power companies, such as the erstwhile Texan giant, plotted the state's electricity crisis. But this week's numbers also reveal structural problems with the state's finances.

That structure is still dominated by an event 25 years ago: the anti-tax movement that gave rise to Proposition 13, a ballot initiative that capped property taxes. Not only were taxes of all sorts made harder to raise, but the state also had to rely on income tax for an ever-greater share of its revenue: it has risen from 18.5% of the total in 1970 to around 50%. Meanwhile, other propositions have set aside parts of the budget to deal with specific problems, leaving only a small portion at the discretion of elected politicians.

The income-tax bias has magnified the dotcom recession. California's economy has actually suffered less than many people expected. San Jose, the capital of Silicon Valley, lost 8% of its jobs in the year to March, the highest proportion of any large city in America. But the southern half of the state added jobs. In all, the state lost just 53,000 jobs—hardly catastrophic. But the state's income-tax revenues, which have been swollen by the proceeds from taxing stock options and capital gains in Silicon Valley, have collapsed (see chart).

Outsiders might argue that California was lucky to have had such a windfall. But Mr Davis is now discovering that it is hard to cut expenditure as fast as Nasdaq tumbled. Most of the windfall went into education. But education is a favourite theme of Mr Davis, and even now that he has increased the school budget per pupil by 34%, to $6,685, California ranks only 35th among the states in education spending. Another mooted target—infrastructure—is also a black spot: California stands 45th in infrastructure spending.



For the budget to pass, it must win the approval of a two-thirds majority in both houses of the state legislature. This means that even if Mr Davis can bring all his fellow Democrats along with him—no easy task, as many on the left of the party dislike the proposed spending cuts—he will have to pick up at least one Republican in the Senate and four in the Assembly. Persuading Republicans to raise taxes is seldom easy, particularly in an election year.

Ever since Proposition 13, the prevailing theme in Californian politics has been voters' reluctance to pay more tax, even for better services. That may be changing.

In part this is simply because the stock of schools, roads and bridges, built in the 1960s, is crumbling. Stephen Levy, director of the Centre for the Continuing Study of the California Economy, points to the way that private-sector firms, fed up with state inaction, are already beginning to take things into their own hands—for instance, building corporate dormitories to overcome the shortage of affordable housing. Direct fees for infrastructure, such as road tolls that vary depending on the volume of traffic, are also starting to appear.

The other change is demographic. Proposition 13 was a victory for white property owners; they are a diminishing breed. Even within the middle classes, anecdotal evidence suggests that the number of people who gain from lower taxes on their homes is getting less important than the rising number of those who fume about their children going to bad schools.

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The Susquehanna River

Dammed if you do

May 16th 2002 | CONOWINGO, MARYLAND
From The Economist print edition

A dam with an unexpected but beneficial side-effect—and a very uncertain future

Lou Jacobson

ENVIRONMENTALISTS are not often fond of dams, which have a habit of trapping migratory fish and disrupting sensitive water ecosystems—not to mention looking ugly. In one respect, though, the Conowingo dam on the Susquehanna River in eastern Maryland is an exception.

Since its construction in 1928, the Conowingo dam has not only generated electricity but also trapped vast amounts of sediment behind its imposing walls. This was not a function the builders had planned for, but in recent years its value has become clear. The water flowing past the Conowingo dam is much cleaner than it would otherwise be. This is important because the Susquehanna is the biggest tributary of the Chesapeake Bay, an enormous, semi-saline body of water that is treasured for its aquatic life.

Like so many American waterways, the bay became badly polluted during the 20th century. But it has regained much of its biological vitality since the early 1970s, thanks to concerted ecological stewardship. In this effort, the Conowingo dam has provided valuable assistance. In a sense, two negative ecological forces cancelled each other out. The monstrous dam has held back a sediment load that had been increased through deforestation, agriculture and development. The level of sediment is roughly what it was before North America was colonised. Even America's once-endangered national symbol, the bald eagle, can be seen perching near the dam, waiting to swoop down and seize a meal of fish by its talons.

But there's a snag. In the early 1990s researchers confirmed that the dam's sediment reservoir was steadily filling up—a fate that had already befallen two smaller, older dams upstream. Although the Conowingo today traps half to two-thirds of the Susquehanna's sediment load, it will no longer be able to trap any new sediment once its catchment area is full. And this added sediment will wreak ecological havoc. Sunlight will be prevented from reaching aquatic plants, small worms will be buried, fish gills and shellfish filters will be put to a severe test. It could also require a costly dredging of shipping lanes if cargo ships are to continue to reach the port city of Baltimore.

Though the reservoir is not expected to top out until at least 2020, officials are already beginning to worry. A natural disaster such as a hurricane or a major flood could upset the existing reservoir and send its contents downstream all at once. Moreover, the cost of remediation could be huge, and must be negotiated between several states and the federal government.

Sedimentary, my dear Watson

Of course, all this assumes that a good solution to the problem exists—and in reality, most experts agree, there is none. Filtering is impractical: 95 pounds of sediment per second is simply too much to cope with. Building a new dam farther downstream would probably cause several towns to be flooded. And, though the cultivation of wetlands upstream to conserve soil may help to curb the ongoing flow of

silt, it will do nothing to reduce the sediment load already held behind the dam.

The remaining option is to dredge the trapped sediment and put it somewhere else, possibly in some of the abandoned mine-shafts that dot the river's banks. Such a plan would be costly, and may prove impossible. The window of seasonable weather is perhaps too brief to complete the work; the banks of the river may be too high to allow for the drying of sediment before it is transported; and plausible modes of transport are in short supply, since the silt cannot be shipped upstream on the unnavigable Susquehanna.

“Unfortunately,” says a spokesman for Exelon, the utility that owns the dam, “it's one of those issues where there's not a silver bullet.” And the fact that the deadline is still two decades away does not help.

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Guns 'n' Poses

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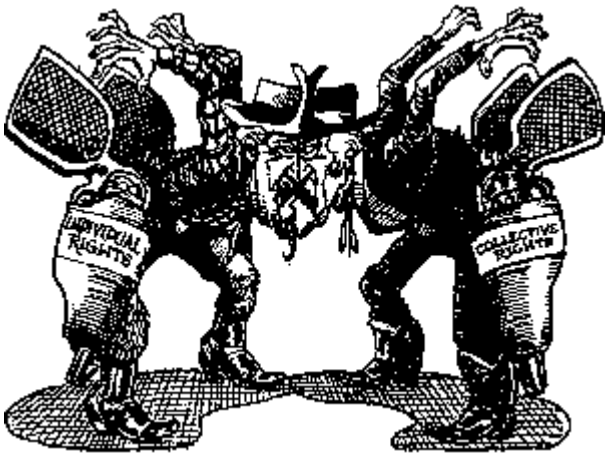

The administration's new position on gun ownership is not as dangerous as its opponents fear

Get article background

EARLIER this month, the solicitor-general, Ted Olson, filed briefs to the Supreme Court in two obscure gun cases. Footnotes in the briefs say the Justice Department now thinks the constitution "broadly protects the rights of individuals...to possess and bear their own firearms". This mild-sounding opinion in fact represented an explosive change in policy. Proponents of gun control accuse the administration of ignoring 60 years of legal precedent, which may be fair; but they also forecast a day when armed maniacs will rampage down streets, a submachine-gun in one hand and a copy of the constitution in the other, which is nonsense. Even if Americans have a clearer right to own guns, that does not mean gun controls will vanish.

Leave aside, particularly if you are not American, your own beliefs about whether guns are a good thing. The current argument in America is not about social policy, but about law. It may come as a surprise to Europeans to find that America has any rules about gun ownership at all. But it does—on everything from what weapons you can own to how you can buy them—and they are rooted in the second amendment to the constitution. The current debate arises because there are two fundamentally different interpretations of what the constitution says.

The first is the "collective" or "states' rights" interpretation. It holds that the meaning of the second amendment is made clear in its preamble: "A well regulated militia, being necessary to the security of a free State..." This implies, say the collectivists, that the right to own guns lies with the people collectively, by virtue of their support for militias (originally a mass military gathering; now, something like the National Guard). The second amendment merely gives state governments the right to set up militias. It does not protect a private citizen's right to own a gun.

The collective view has held sway in federal courts and administrations for most of the past century. The last time the Supreme Court looked at the second amendment (in 1939), it ruled that the government could make sawn-off shotguns illegal on the ground that there was "no reasonable relationship to the preservation or efficiency of a well-regulated militia". Federal courts interpreted this specific ban as a reason to uphold all manner of gun-control laws. Hence an iron link was forged: the collective view of the second amendment justifies gun control.

The other view focuses on the rest of the second amendment: "The right of the people to keep and bear

arms shall not be infringed.” If you ignore the preamble, that sounds like a guarantee of everyone's right to own guns. Supporters of this “individualist” interpretation say the preamble does not materially affect the amendment because, when it was drawn up, “the militia” and “the people” were pretty much the same thing. They concede that, elsewhere in the constitution, “the people” sometimes means everyone collectively, not as individuals. But by no stretch of the imagination can “the people” mean “the states”—so the right does indeed belong to every American.

The individualist view has long been espoused by the National Rifle Association. It opposes almost all gun controls on the ground that they will lead eventually to the confiscation of firearms, the citizen's last defence (says the NRA) against tyranny. This is the position now being adopted by the Bush administration via Mr Olson's footnotes.

Given decades of precedent and the link between the collective view of the second amendment and gun controls, it is no wonder that critics have hit the roof. They accuse the administration of adopting a marginal view of the constitution in order to chuck out background checks and limits on ammunition purchases. Legally speaking, however, this view is wrong on two counts. First, even though the Supreme Court has not looked at the second amendment for 60 years, scholarly legal opinion increasingly supports the individualist case. And, second, that position does not necessarily entail the abolition of gun control. The apparent choice on offer to Americans—a collective interpretation plus gun laws, or an individual interpretation with no limits—is a false one.

So look to the 14th amendment

Akhil Reed Amar, a professor at the Yale Law School, is a good exponent of this new view. He is no gun-toting libertarian. He is sceptical of the claim that “the people” in the second amendment really means everybody. But he still thinks the constitution embodies an individual's right to bear arms, largely because of another of the constitution's vital amendments, the 14th (adopted just after the civil war). This says that “no state shall make or enforce any law which shall abridge the privileges or immunities of citizens.” That does not sound like a reference to guns. But the 14th amendment was adopted to make constitutional two other laws, the Civil Rights Act of 1866 and a companion statute which says that “personal liberty...including the constitutional right to bear arms, shall be secured to and enjoyed by all the citizens.”

This is strong evidence in favour of the individualist interpretation. But it can also be used to back gun control. By providing constitutional guarantees against confiscation, it undermines the NRA's slippery-slope argument. Indeed, the individualist view of the right to bear arms can be perfectly consistent with gun laws that define and restrict that right—as shown, so far at least, by one of the judgments that Mr Olson supported.

Last year the Fifth Circuit court of appeals in Louisiana heard a case about a man who had been banned from owning a gun and told to stay away from his wife because of a history of domestic violence. He said the gun ban was unconstitutional. The court, for the first time in decades, rejected the “collective” view of the second amendment and found there is indeed an individual right to own guns. A triumph for gun nuts? Hardly. The court held his right was not absolute—and found against him.

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Cuba and the United States

Playing softball in Havana

May 16th 2002 | HAVANA
From The Economist print edition

EPA

Jimmy Carter's pilgrimage will not bring swift change in Cuba, nor in American policy. But it has stirred things up

Get article background

ON THE face of things, it seemed that Jimmy Carter, a former president of the United States, could achieve little by his visit to Fidel Castro's Cuba this week. After all, Mr Carter has been out of office for more than two decades, he is a wishy-washy Democrat while muscular Republicans rule the White House, and, however well-intentioned, he is an American visiting a regime locked in 40 years of mutual enmity with the United States. In what looked like a torpedo aimed at Mr Carter's visit, John Bolton, a State Department official, announced last week that Cuba should be added to the list of rogue states involved in making, or helping to make, weapons of mass destruction.

Yet, despite these auguries, there was something historic about the visit of the highest-ranking American to the island since Mr Castro took power in 1959. In a speech broadcast live in Spanish on television and radio, Mr Carter criticised Cuba's lack of democracy and called for free expression, as well as for the lifting of the United States' trade embargo against the island. He also mentioned approvingly a petition signed by more than 11,000 Cubans, presented to the National Assembly on May 10th, which calls for a referendum on free speech and elections. According to the constitution, any such petition must be debated and voted on by the legislature.

His host, seated in the front row of the audience at Havana University, showed no reaction. Ordinary Cubans, whose first news of the petition came from Mr Carter, have not heard such public criticism of their political system since the pope toured the island four years ago. That visit led to increased religious tolerance. Will Mr Carter's trip bring political changes?

Mr Castro, now a hoary 75, and his Communist Party have maintained a tight political grip on the island over the past decade, despite an economic upheaval that has seen foreign tourists and investors replace sugar and Soviet subsidies as the island's mainstays. Having quarrelled lately with Mexico and several other Latin American countries over human rights, the Cuban leader welcomed Mr Carter's visit as evidence that his government is not a pariah. He was unusually deferential to his guest, whom he has always praised for his efforts, when president, to normalise relations between the two countries.

His first gesture came a week before Mr Carter and his wife Rosalynn arrived. Officials released Vladimiro Roca, the island's leading dissident, two months before the end of a five-year jail sentence. On Mr Carter's arrival at Havana's airport the Stars and Stripes flew, and the band played the American national

anthem. “You don't hear that here too often,” remarked Mr Castro, dressed in a dark suit instead of his usual military fatigues.

Cuba's government considers the island's small but increasingly self-confident dissident and democratic movements to be counter-revolutionaries in the pay of the United States. The dissidents are either repressed or ignored. So it was to general surprise that Mr Castro said his guest could meet whomever he liked. Mr Carter duly held several meetings with dissidents, including Osvaldo Paya, the leader of the petition movement.

That pleased the anti-Castro exiles in Miami, who had accused Mr Carter of playing into his host's hand. But Mr Castro exploited his guest's presence to defend himself against the biological-weapons charge, inviting him to visit biotechnology plants. Mr Carter obliged, saying that he had been assured by American intelligence officials before his visit that Cuba posed no threat.

The dissidents were heartened by Mr Carter's visit. “But anyone who expects immediate changes is not being objective,” said Mr Roca. It is indeed likely that everything will return to normal once Mr Carter and his retinue of American reporters return home.

On May 20th, Mr Bush is expected to announce steps to tighten the trade embargo. These may be minor, such as more fines for the growing numbers of American tourists who visit the island. He may also announce more money for TV Marti, an American propaganda outfit. Neither the Americans nor Mr Castro seem in the mood for fresh thinking on Cuba. But some Cubans are starting to stir. And Mr Carter may have given that process more encouragement than the trade embargo and TV Marti combined.

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Politics in Brazil

Who's afraid of Lula?

May 16th 2002 | SAO PAULO
From The Economist print edition

Investors are, despite the left's efforts at moderation

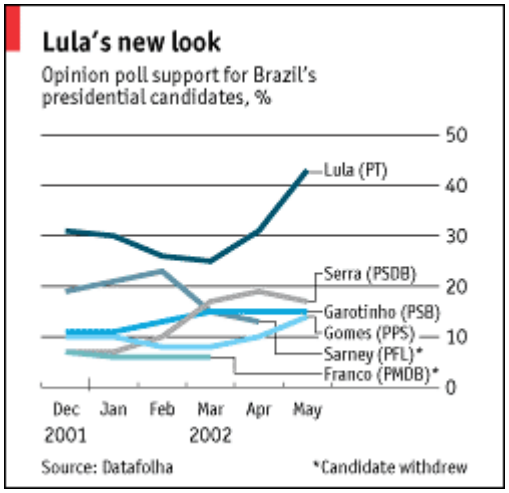
Get article background

Reuters

COULD this be the year in which Luiz Inacio Lula da Silva, the founding leader of the left-wing Workers' Party (PT), wins Brazil's presidency, at his fourth attempt? The election is not until October. But in the past two months, Mr da Silva has begun to surge ahead in the opinion polls (see chart). His strongest potential opponent, Jose Serra, the candidate of President Fernando Henrique Cardoso's centrist Social Democrats, has faltered. Investors have begun to take a Lula victory seriously: Brazil's stockmarkets and the value of its bonds and currency have plunged in recent weeks. Are the worries justified?

Once a fiery trade unionist who called for Brazil to renege on its debts, Mr da Silva insists that investors have nothing to fear. “I have changed, and changed a lot,” he says. And changed out of his customary jeans into a dark suit, just to stress the point. This month he told business leaders that he would maintain economic stability and the fight against inflation. He said he supports free trade as long as richer countries gave Brazil “fair access” to their markets. The bosses praised this new “social democratic” rhetoric but complained of a lack of detail on how Mr da Silva would finance ambitious plans to cut poverty and help industry.

Last year, in a draft policy document, the PT talked vaguely of capping debt payments. But this week Mr da Silva insisted that a PT government would service Brazil's public debt of 661 billion *reais* ($280 billion) normally, seeking better terms only when loans expired (the routine practice of all governments).



But is the PT really committed to stability? Guido Mantega, Mr da Silva's economic adviser, says that since Brazil is likely to exceed its “unrealistic” central inflation target of 3.5% for 2002, this should be raised to perhaps 5%. He argues that this would let the Central Bank cut interest rates, lowering the government's borrowing costs and boosting growth. If only it were so simple. The target will indeed be missed. But going soft on inflation might make lenders demand higher returns and, by weakening the currency, would increase the cost of the large chunk of public debt that is tied to the exchange rate.

The key economic test for Brazil's next government will be whether it sticks to the large fiscal surpluses (before interest payments) required to service the debt. Despite Mr da Silva's expensive promises (which are echoed by other candidates), he insists that he would be fiscally responsible. He points to his party's record in municipal and state governments. Raul Velloso, an expert on public finances, says that the PT has indeed proved prudent and efficient at running city halls, though its state governors have been less so. But, nationally, the party has fought against every step in Mr Cardoso's long battle to improve the public finances. Contradicting its talk of fiscal rectitude, the PT has challenged in the Supreme Court the fiscal-responsibility law, which imposes limits on spending by local government.

The PT, as a fairly new party, has a good record in fighting corruption. And it promises to push harder to pass vital reforms, such as that of the cumbersome tax system. But Mr Cardoso has failed to achieve

such measures despite heading a coalition with a huge majority in Congress. The PT has yet to strike any national electoral pacts. It hopes to win around 70 of the 513 seats in the lower house of Congress (up from 58 in 1998). But to get anything done, it would have to hold its nose and strike deals with political foes. After a fruitless first year in office, that is now the fate of Marta Suplicy, the PT mayor of Sao Paulo, Brazil's biggest city. In this she faces resistance from her more leftish councillors.

Cristovam Buarque, a former governor of Brasilia and a leading PT moderate, says that much of the uncertainty about what a Lula government would be like reflects the candidate's own indecision. He lost the 1994 presidential election by being slow to back Mr Cardoso's inflation-beating *real* plan. Last month, Mr da Silva floated the idea of raising the top income-tax rate from 27.5% to 50%, only to back-pedal swiftly.

The besuited Mr da Silva and his party have moved a long way towards reassuring voters, if not investors, that they can be trusted with the economy. But they have yet to dispel all doubts. Unless they do so in the coming months, Mr da Silva could yet lose his fourth, and this time surely final, chance of the presidency.

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Latin America and Europe

Distant friends

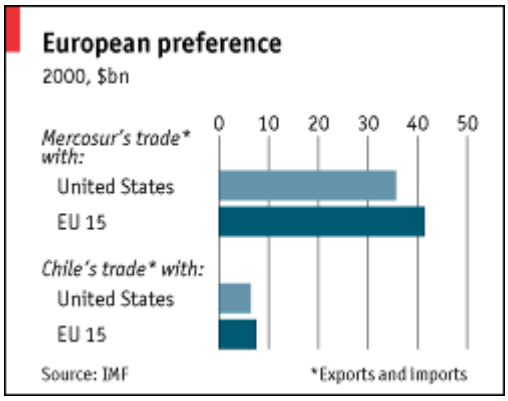
May 16th 2002
From The Economist print edition

A test of passion in Madrid

THREE years ago, in Rio de Janeiro, the heads of government of the European Union met their counterparts from Latin America in an effort to breathe new life into an old relationship. Apart from declaring their commitment to a “strategic partnership”, the EU also agreed to launch free-trade talks with the Mercosur trading block and with Chile. The aim on both sides was to dispel the notion that Latin America is simply the United States' backyard.

Apart from ties of history, language and migration with Latin America, the EU is the largest (non-military) aid donor and foreign investor in the region. For many South American countries, trade with Europe counts for more than with the United States (see chart). But the pull of the United States increased in the 1990s. The Rio Summit was a response to similar gatherings of the Americas, and to their proposed Free-Trade Area (FTAA).

How passionate is this Euro-Latin love affair? On May 17th and 18th in Madrid, the two sets of leaders were due to meet again. The timing is hardly propitious. From Argentina to Venezuela, much of Latin America is locked in economic or political turmoil. With high hopes of liberal reform dashed, Latin America “is in danger of becoming the world's forgotten region”, says Denis MacShane, a British minister.



So the first test of the Madrid meeting will be one of relevance. A Spanish official says he expects all the Europeans to turn up (bar Ireland's Bertie Ahern, who has an election), though several may leave early. He says he would not be sorry if Cuba's Fidel Castro stayed away, since “there aren't many people who want to talk to him.”

The summit will see the signing of a trade agreement between the EU and Chile (in Latin America, only Mexico already has such an accord). For Chile, this is a big step: although four-fifths of its exports to the EU (which totalled $4.6 billion in 2001) already enter tariff-free, the agreement will guarantee permanent market access. Its fruit exporters like the accord's dispute-settlement machinery; though its sparkling wine will no longer be allowed to be called “champagne”, it will get duty-free status after four years. The government estimates that the accord could boost Chile's exports to the EU by 15% (though this may come partly at the neighbours' expense).

Ricardo Lagos, Chile's president, says that the agreement supports his centre-left government's political agenda because it contains references to democracy and human rights. Chile is also fairly close to clinching a bilateral free-trade deal with the United States, and will use these agreements to support its claim that it is a shining exception to its neighbours' disorders.

By contrast, the EU's trade talks with Mercosur have moved slowly. That is partly because of Argentina's problems: in practice, Mercosur is no longer operating as a customs union, in which all the members have uniform external tariffs. But the Mercosur talks were always going to be trickier because of the EU's farm protectionism: Brazil and Argentina, Mercosur's main members, are agricultural powerhouses. In Madrid, the EU may propose a ministerial meeting to revive the talks. But Argentina's president, Eduardo Duhalde, will be told that help for his country can come only through the IMF.

European officials say that both regions share a commitment to multilateralism in tackling problems,

from global warming to the International Criminal Court. They see scope for co-ordination there. The leaders may also accept a Colombian request to add the left-wing FARC to the EU's official list of terrorist groups. Terrorism is a subject on which Jose Maria Aznar, Spain's prime minister, needs no persuading. Three days before the summit, the police said they had forestalled a planned attack by ETA, the Basque separatist group.

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Politics in Canada

Chrétien and on and on

May 16th 2002 | OTTAWA
From The Economist print edition

The prime minister may retire soon—or may not

Get article background

Reuters

Whose footsteps behind him?

JEAN CHRETIEN, Canada's prime minister since November 1993, is fond of teasing ambitious colleagues and inquisitive journalists about his retirement. The closest he has come to stating his intentions was when he said last year that he wanted to remain in office long enough to celebrate the 40th anniversary of his entry to the House of Commons as a 29-year-old member of Parliament in April 1963. But he has since dropped hints that he might like to lead the Liberals into a fourth election, presumably in 2004.

Skilled survivor though he is, can Mr Chrétien control his own destiny? The loss of two safe Liberal seats in by-elections on May 13th will increase the pressure on the prime minister to go sooner. The Liberals expected to hold six of the seven seats at stake. But the Progressive Conservatives scored a surprise victory in a Newfoundland seat, and the leftish New Democrats won an industrial constituency in Windsor, across the border from Detroit. Both had been held with large majorities for three decades by popular Liberal veterans whom Mr Chrétien had dropped from his cabinet. The Liberals were not helped by criticisms by the auditor-general, and others, of the government's use of advertising firms in Quebec friendly to the party. Mr Chrétien argued that the government's extravagant sponsorship of festivals and almanacs had reduced support for separatism in the province. Ridiculous, said Quebeckers.

In fact, the pressure for Mr Chrétien to retire has been mounting for months. The Liberals are divided into several camps. By appointing John Manley, a former foreign minister, as his deputy in January, the prime minister seemed to make him his heir. But both men face a powerful rival in Paul Martin, the finance minister, whose supporters control many, perhaps most, of the 301 constituency Liberal associations. These will send delegates to a party convention due next February, when a vote on the party leadership is obligatory.

Mr Chrétien has gathered together a team to rally support in the leadership vote. And he seems to be campaigning already. Stealing some of his finance minister's sunshine, he made an unscripted announcement that the government plans to pay off up to C$10 billion ($6.4 billion) of the national debt this year. And last month he replaced Mel Cappe, the cabinet secretary, who as Canada's top civil servant had just announced a big shake-up of the bureaucracy. Mr Chrétien's surprise choice for the job, Alex Himelfarb, is an expert on social policy who may give the government new life. The appointment seemed aimed at those who say Mr Chrétien has run out of policies, and simply stays because he likes the job. Mr Martin, who was defeated by Mr Chrétien for the leadership in 1990, is the chief architect of Canada's economic steadiness—and of its seemingly quick recovery this year from a feared recession that never quite happened. His supporters hope that the prime minister will announce in December that he indeed plans to step down next April, clearing the way for their man.

The by-elections may have made that more likely. Mr Chrétien would bequeath a commanding majority in the House of Commons, where the opposition is divided four ways. On the other hand, Mr Chrétien, who loves a scrap, may be girding himself for battle with Stephen Harper, the newly elected leader of the Canadian Alliance, who entered Parliament through one of this week's by-elections. Mr Harper would be the eighth opposition leader the prime minister has faced. Mr Chrétien teases Canada yet.

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India and Pakistan

Dicing with Armageddon

May 16th 2002 | DELHI AND LAHORE
From The Economist print edition

The latest terrorist outrage in Kashmir has pushed India and Pakistan a little closer to the brink

AP

Get article background

"IT IS just this type of barbarism that the international war on terrorism is determined to stop." So said Christina Rocca, the top American diplomat for South Asia, of the killing on May 14th of 31 people, most of them soldiers' wives and children, at an army camp in Kaluchak in the Indian state of Jammu and Kashmir. It is also the sort of attack that India has given warning would provoke retaliation against Pakistan, which could spark the first war between nuclear powers.

Mrs Rocca was already shuttling between the Indian and Pakistani capitals to head off such a war. India's army has been mobilised along its border with Pakistan since December, after a terrorist attack on its parliament. The military threat, coupled with international pressure on Pakistan's president, Pervez Musharraf, was supposed to curtail attacks on India originating from Pakistan. Mrs Rocca's mission may be one of the last chances for this "coercive diplomacy" to work.

It had seemed to be working, for a while. General Musharraf banned several violent Islamist outfits, including groups fighting Indian rule in Kashmir, arrested their leaders and froze their accounts. In January he pledged to crack down on extremism and to prevent terrorists from using Pakistan as a staging post for attacks on India. The Indians never believed him and now, they say, evidence of his perfidy is in. General Musharraf has released three out of every four people he arrested. Terrorist camps have been re-established in the part of Kashmir controlled by Pakistan, with some 3,000 inmates, say Indian officials: their infiltration into Indian Kashmir has not slowed down since last year, and is sure to speed up once snow melts from the mountain passes. And now terrorists have staged the bloodiest attack since Kashmir's parliament was bombed in October.

There are two ways to avoid retaliation: General Musharraf could convince India that he is serious about reining in the terrorists, or India could continue to answer terrorism with what will come to look like empty threats. General Musharraf may lack either the power or the inclination to do the first; the humiliation of the second is becoming unbearable to India. Its government, looking feeble after mishandling massacres of hundreds of Muslims in the western state of Gujarat, is under increasing pressure to act. The prime minister, Atal Behari Vajpayee, said that India "will have to counter" the massacre, but did not say how or when.

Pakistan has long embraced the cause of freeing Kashmir, India's only Muslim-majority state, from Indian rule while claiming (unbelievably) that it gives only diplomatic and moral support to anti-Indian militants. September 11th and its aftermath twisted that alliance in ways not fully understood. General Musharraf made enemies among *jihadi* groups by backing the American war against terrorism. He appointed a new chief of the ISI intelligence agency, the main patron of anti-Indian groups, in part to be able to control them. Pakistani analysts reckon attacks such as this week's, possibly assisted by rogue ISI operatives, are directed as much at General Musharraf's rule in Pakistan as they are at India's rule in Kashmir.

Yet the general also has reasons not to crack down too hard. One is to avoid making terrorists angrier than they already are. Another is that India plans to hold “free and fair” elections in Kashmir by the autumn and is trying to entice moderate separatists to participate. If turnout is high and the elected government looks popular, India will no doubt declare that Kashmiris have accepted their lot. Earlier this month General Musharraf described attacks on Indian forces (but not on civilians) as part of a “legitimate freedom struggle,” a definition that enrages India.

He fires from behind multiple shields. Would India attack the Americans' chief ally in the war against al-Qaeda? Pakistan has already complained that India's deployment is diverting its army from that fight. If war starts, many Pakistanis think the United States will step in to stop it. Would India really risk taking on a nuclear-armed adversary? Pakistan has repeatedly stated its willingness to go nuclear in response to a conventional attack.

But the price of Indian restraint rises with each outrage; the cost of retribution, meanwhile, is starting to look acceptable. Indian strategic thinkers have recently argued that India can wage a “limited war” against Pakistan without risking a nuclear exchange. This, they say, is because the adversaries understand each other: India would not push Pakistan so hard that it had to resort to nuclear weapons, and vice-versa. Besides, if Pakistan did deploy its nuclear missiles, says K. Subrahmanyam, a leading strategist, the United States “would destroy them.” All this sounds to many like dangerously wishful thinking.

If it gives up on diplomacy, India's likeliest course would be to mount “surgical” raids on terrorist camps in Pakistan-controlled Kashmir, which is not formally part of Pakistan. But the risk of escalation is always present. V. R. Raghavan, a former director-general of Indian military operations, argued in a recent paper that any conflict between India and Pakistan could easily spiral out of control. India's aggressive plans for fighting conventional wars are now matched against Pakistan's aggressive doctrine for nuclear ones. An “escalation from a conventional to a nuclear war, within one or two days of the outbreak of the war, is not implausible,” General Raghavan writes.

Indian leaders are aware of such risks, and pray that Mrs Rocca's mission will provide some escape. They are not hopeful. After years of terrorism, taking a gamble with Armageddon is starting to look to some like the lesser evil.

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East Timor

Freedom at midnight

May 16th 2002 | DILI
From The Economist print edition

After centuries of oppression, the birth of a nation

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AP

Gusmao's triumph

AT MIDNIGHT this Sunday, May 19th, the East Timorese will get the best piece of news of their lives, indeed of their history. After centuries of foreign domination, sometimes exceptionally bloody, they will finally have their own independent state. If a banality can be excused on this occasion, a dream will have come true.

Feelings of quiet elation have been evident for weeks. The brightly painted buildings of Dili are a far cry from the mess the Indonesians left behind in late 1999. Thousands of refugees have been streaming back from the other half of the island, West Timor, which remains part of Indonesia. Foreign donors have agreed to contribute $440m towards East Timor's budget, which should see the administration through its first three years.

The United Nations administration has taken some knocks but on balance is reckoned to have been a success. Its chief, Sergio Vieira de Mello, who during the transition period has been virtual head of state, will formally hand over his authority to the president-elect, Xanana Gusmao, a former guerrilla commander and the most idolised man in the country. A scaled-down UN mission will remain in East Timor but all key decisions will be taken by the new government.

Indonesia's President Megawati Sukarnoputri is expected for Sunday's midnight festivities. She urged Timorese to reject independence in the UN-run referendum that led to East Timor's freedom, so her presence indicates an attempt to heal the relationship between the two countries. In West Timor the anti-independence militias are a shadow of their former selves. Their chiefs occasionally make belligerent noises, but Indonesia finds them an embarrassment now. Some have been given jobs in government, on condition they shut up.

Few will begrudge the East Timorese their moment of happiness. But the fact remains that this tiny country of about 750,000 people starts life in poverty. Many of the working population earn no more than 55 American cents a day. Large parts of the country have no electricity. Education and health services are limited. The Indonesian occupation will not be easily forgotten: some 200,000 people (of a population then of 600,000) are thought to have died as a result of war, famine and disease after the paratroopers moved in in 1975. Only in the past two years of UN administration have the East Timorese glimpsed a passably decent future.

The new chief minister, Mari Alkatiri, accepts that East Timor will be dependent on foreign aid for several years. But he points out that its economic prospects are robust. Large oil and gas deposits in the Timor Sea are likely to come on stream in the next few years. There are lingering disputes with Australia and Indonesia about who precisely owns which bit of the Timor Sea, but a small amount of tax revenue from oil prospectors is already coming in, and should rise to a useful $70m a year. Mr Alkatiri has proved a tough negotiator with his neighbours on this issue. The half-island yields plenty of agricultural produce, even if distribution is haphazard. Experts from Brazil say coffee production could be expanded.

Mr Alkatiri and Mr Gusmao appear to be working together better than some people expected. Both the legislative election last year and the presidential election in April went smoothly. Concerns that Fretilin, a formerly Marxist party, would cause trouble in government have been largely allayed.

There are worries about whether the new police force and the army will be efficient, and whether the weak legal system will prove resistant to bribery. There are fears that kangaroo courts may be set up if the legal courts are thought to be too slow. A “truth and reconciliation commission” similar to South Africa's is about to start work, but has been accused of dragging its feet.

Still, for the moment gloom is out of fashion. The East Timorese want to enjoy their new nation. One of Mr de Mello's final acts was to launch East Timor 2020, an easy-to-understand version of the government's development plan, drawn up with input from East Timor's 13 districts. In every one of them, people came up with the same top priority: education. East Timor is ready to escape from its terrible past.

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Australia

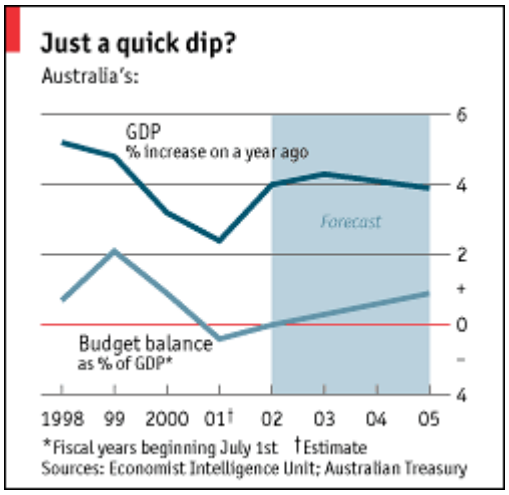
In the red, but for how long?

May 16th 2002 | SYDNEY
From The Economist print edition

An unplanned budget deficit

SINCE it came to power six years ago Australia's conservative coalition government, led by John Howard, has prided itself on producing a steady series of budget surpluses after its Labor Party predecessors left a string of deficits. This year was expected to be no exception, especially after Peter Costello, the treasurer (finance minister), gave a "guarantee" six months ago that "we will keep the budget in surplus". Since then Australia has continued to boom, with the strongest growth rate of any rich economy, robust business investment, low inflation and falling unemployment. So when Mr Costello delivered his seventh, and perhaps one of his last, budgets to Parliament in Canberra on May 14th, it came as something of a shock when the projected outcome for fiscal 2001-02 was a deficit of A$3 billion ($1.65 billion).

When Mr Costello made that pledge last November, Australia was in the throes of one of the most highly charged general election campaigns in years. Faced with opinion polls early last year that predicted a defeat, the government clawed its way back to a comfortable third term with a spending spree that involved dropping indexed taxes on petrol, giving more money to elderly Australians and making cash grants to first-home buyers. It followed this up by spending more on defence in the wake of September 11th, and by getting tough on mainly Afghan asylum-seekers landing on Australia's northern shores. The policies that rescued the government then have now sent Australia into the red.



On top of last year's big outlays, Mr Costello pledged in his budget another A$2.5 billion over the next five years to strengthen Australia's borders and upgrade security within the country. The measures include building a processing centre for asylum-seekers on Christmas Island, off the north-west coast, setting up a second counter-terrorist tactical assault group and establishing a regiment to respond to chemical and biological attacks. For a country that has always had the advantage of being a long way from any terrorist front line, some of the spending would seem to be an over-reaction, driven as much by politics as fiscal prudence.

The government can probably withstand any political flak from its lapse into deficit. Australia's economy has shown remarkable resilience in the face of downturns in those of Japan and the United States, its biggest trading partners. Structural reforms started by former Labor governments, and augmented by Mr Howard, have made the economy more competitive than ever. A cheap Australian dollar has helped exporters. Low interest rates, and the housing grant, have stimulated a property boom: in Sydney, small, inner-city houses in what were slums 100 years ago now sell for A$1m each.

The scale of the boom has worried the Reserve Bank, which stepped in on May 8th to raise interest rates by 0.25 % to 4.5%, the first rise in two years. The bank cited fears of inflation, rising household debt and an "imbalance" from the overheated housing market. Some economists suggest one, and possibly two, more rate rises could come by the end of the year. By then Mr Costello will be planning next year's budget, which he said this week would involve a return to surplus. Mr Costello himself is waiting to succeed Mr Howard as leader of the Liberal Party, the coalition's senior partner, amid speculation that Mr Howard will stand down next year. If he is to win the next election as leader of a big-spending government, Mr Costello will need all the surpluses he can manage.

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Japan

We're number two!

May 16th 2002 | TOKYO
From The Economist print edition

Japan gets knocked down yet another list

IN 1992, as Japan's economy was entering a decade of decline, the momentum of its past success was just beginning to pay off. One pay-off that inspired much pride was the country's rise to the top of the world's aid donors' list, a spot it gained by pipping the United States. The shift, coming just after its military inaction in the Gulf war, inspired many Japanese with a new self image: as wealthy benefactors who would rather fight poverty than wars. Less idealistic Japanese at least hoped for respect and international clout.

As Japan's economy limps onward, however, the country keeps finding fresh ways to lose friends and stop influencing people. South-East Asian neighbours are talking of bypassing Japan to form a free-trade area with China, the new star economy on the block. With each new downgrade of its credit ratings, Japan lands in the symbolic company of a more distasteful batch of sovereign borrowers (see article). And now, perhaps worst of all, Japan has lost that top spot on the donors' list that once occupied the top shelf in its trophy case.

According to the Organisation for Economic Co-operation and Development, which released its list on May 13th, America increased its overseas development assistance (ODA) to $10.9 billion in 2001, retaking the top spot that it lost in 1992. Japan's foreign aid fell by nearly $4 billion, to $9.7 billion. Part of that drop reflects the yen's 12.7% slide against the dollar, but other factors were also at work. As its public finances unravel and citizens face increasing prospects of belt-tightening, Japan's government is having to rethink aid as well. Last year its ODA fell from 0.28% to only 0.23% of gross national income. This is still more than double America's ratio. But Japan has pledged up to $500m for Afghanistan, and it remains keen to butter up its South-East Asian neighbours. Other poor countries seeking a benefactor may have to look elsewhere.

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North Korean refugees

Down to the wire

May 16th 2002 | BEIJING
From The Economist print edition

Refugees are straining relations between China, North Korea and Japan

AP

A diplomatic incident

VERY often, the sudden appearance of barbed wire marks a political crisis. And so it is in China, where the authorities have lately been scrambling to throw up barbed wire and other unsightly barriers around diplomatic installations, in order to slow the rising tide of North Koreans seeking political asylum by hopping fences and dashing through gates into foreign missions.

Five North Koreans thought they had reached their goal when, on May 8th, they entered the premises of Japan's consulate in China's north-eastern city of Shenyang. But Chinese police followed them in and dragged the group—which included a toddler—back out and took them into custody. Captured in a dramatic bit of news footage that has been replayed constantly on Japanese television, the episode has sparked a nasty row between China's government and Japan's over whether Chinese police were within their rights to act as they did. Prickly at the best of times, Japanese-Chinese relations have turned sour with mutual accusations of lying. In Japan, the government has come under harsh criticism for its clumsy handling of the episode.

But the incident is not an isolated one, and there will be more to come. Three other North Koreans entered the United States consulate in Shenyang during the same week, and another pair got into the Canadian embassy in Beijing. In March, a group of 25 made it into the Spanish embassy in Beijing, and from there, eventually, on to asylum in Seoul.

And so the barbed wire. It is China's bad luck to share a long and porous border with a bankrupt and repressive neighbour, and it has had to contend with a steady flow of North Korean escapees crossing the Yalu River into north-eastern China. International agencies estimate that as many as 300,000 North Koreans have crossed over.

But bad luck aside, China's own political calculations have played a role in making things what they are today. Though China's once-warm ties with North Korea have cooled in the past decade, the two remain nominal allies in socialism, and China still works hard to avoid antagonising its neighbour.

For instance, China refuses to allow escapees to travel directly to South Korea, as most of them wish. It declines to call them refugees, preferring to label them illegal economic migrants. To call them refugees would not only imply that North Korea's government was repressive, but could also oblige China to allow international agencies in to operate along the border area.

Ever wary of attempts by outsiders to interfere in its affairs, China will go to great lengths to avoid that step. But if migrants keep coming over the walls, the idea of allowing someone else to try to handle the problem may start to look more attractive than living with so much barbed wire in Beijing.

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Afghanistan

The invisible enemy

May 16th 2002 | BAGRAM
From The Economist print edition

Invisible—or dead?

THE remaining al-Qaeda and Taliban fighters left in Afghanistan are proving to be maddeningly elusive—if they exist at all. British and American troops returned to their bases on May 13th after operations that once again failed to find enemy fighters. In one raid, five people were reportedly killed and 30-odd captured: but it now looks as though they may not have been from either of the wanted groups.

Still, at least some of the enemy seem to be out there somewhere. For the past month or so rockets have been fired on to Khost airfield, in eastern Afghanistan, close to the border with Pakistan. This is a base of American special forces and some of the 101st Airborne Division. Last weekend 130 Americans from a “quick reaction” unit searched the nearby hills for the rocketeers. A successful operation, they declared on their return. Did they find the enemy? The American commander said they forced the enemy to move its rocket site.

The British have been searching mountain ranges in south-eastern Afghanistan. For 16 days Royal Marines trudged from mountain top to mountain top without finding a single terrorist. They did find and destroy a cache of weapons and ammunition in four caves, and declared the mission a success. Some say, though, that the ammunition belonged to friendly warlords, and not to al-Qaeda at all.

The top brass puts a brave face on the setbacks. Major-General Franklin Hagenbeck, who commands the coalition forces in Afghanistan, insists that the enemy remains dangerous. Although it had difficulty massing its forces, recruiting new members and moving freely in Afghanistan, it could still carry out operations.

Intriguingly, Brigadier Roger Lane, the senior British commander in Afghanistan, painted a more optimistic picture. Last week he questioned how effective the enemy now is. He suggested that reduced to small groups, composed of no more than two or three fighters, the Taliban and al-Qaeda forces are no longer a great threat. He reckons that offensive operations could be completed in a matter of weeks rather than months, given that “they're not showing a predisposition to reorganise and regroup to mount offensive operations against us.” The reality may anyway be that the terrorists have moved into Pakistan, where special forces are helping Pakistan's army to search for them.

A recent British visitor to the war zone, General Bob Fry, commandant-general of the Royal Marines, suggested that the next moves to stabilise Afghanistan could be more political than military. From now on, he said, more work would be done to train an Afghan national army. Such a force would give support to the *loya jirga*, or grand council, meeting in June. The Afghan government would be urged to take steps to solve internal conflicts between warlords. At least in private, some American policymakers strike a similar note, though Washington's hawks remain allergic to any talk of “nation-building”.

At present Afghanistan's foreign legions are in two groups. There is the International Security Assistance Force, so far deployed only in Kabul. And there is the American-led fighting coalition. All of these troops can have an important psychological effect as a token of the outside world's commitment to a more-or-less peaceful Afghanistan. Afghanistan's interim leader, Hamid Karzai, has quietly told his western friends that he does not mind what the foreign forces call themselves as long as they are prepared—mostly just by being there—to provide a stable atmosphere. That will amount to nation-building by another name.

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Reforming the Palestinian Authority

The rocky road from war to talking

May 16th 2002 | GAZA
From The Economist print edition

A reformed Palestinian regime is an Israeli condition for negotiation. The Palestinians want this too, but are sceptical

Getty

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THE division of labour is agreed, at least in principle. America steers Israel, and the Arab states steer the Palestinians, away from violence, and back to political negotiation, with the first stop being some kind of peace conference this summer.

Last weekend there were actual signs of steering. The Israeli army had been poised to invade Gaza in retribution for a suicide attack near Tel Aviv that killed 15 Israelis. But Ariel Sharon called the operation off on May 10th. The same day, Egypt, Saudi Arabia and Syria reaffirmed their support for a comprehensive peace with Israel, in return for Israel's comprehensive withdrawal from the occupied territories, and denounced violence in all its forms.

A stream of Egyptian envoys are telling Yasser Arafat that the time has come to choose between peace and the *intifada*, with their blunt preference being the former. And the Saudis are saying that they will use their good offices to persuade Hamas and Islamic Jihad to end their "martyrdom" actions against Israeli civilians.

The path to peace remains extraordinarily rocky. Not only does it require a ceasefire, but it now also requires a "reformed" Palestinian Authority (PA) to police that ceasefire. The American, Israeli and Arab refrain is that Mr Arafat should set his house in order and bring his 12 disorderly security forces under a single command. George Bush has said that he will soon dispatch George Tenet, the CIA's director, to help to put the new force in place.

The Palestinians themselves deeply desire reform, though they are sceptical that it can be delivered by the CIA. They have long been calling for change in Mr Arafat's autocratic style of government, and these calls became a clamour in the aftermath of Israel's re-conquest of the West Bank cities. Vulnerable and leaderless, the Palestinians watched as the PA's defences collapsed, institutions crumbled and young policemen were left to try to fend off, and to be killed by, the region's mightiest army.

From grassroots activists to politicians, the insistent cry is for elections, with a new "national emergency" government formed to deal with a crisis that is both political and humanitarian. Even Mr Arafat, stung by the cool reception he received on tours this week of Bethlehem, Nablus and Jenin, has sniffed the breeze, promising change on all fronts and issuing decrees to ensure the independence of the judiciary. In a speech to the Palestinian parliament on May 15th he promised a "complete revision" of the system, and "immediate preparation for [dateless] elections".

All Palestinians want change. But few believe it will actually happen. One reason is that experience tells them that Mr Arafat is never more open to democracy than when his popularity is plummeting. And his popularity is starting to drop now, as people forget the courage he showed under the Israeli onslaught, and remember the policies that led up to it.

As Palestinians know, Mr Arafat seems never more open to democracy than when his popularity is

Another reason for doubt is the distaste that many Palestinians feel for reform's new "champions". In recent weeks a nasty, snarling fight has erupted between

plummeting

Muhammad Dahlan and Jibril Rajoub, the PA's security chiefs in Gaza and the West Bank, both of whom have been touted by Israel and America as young, able and reform-minded successors to Mr Arafat. Their squabble has little to do with reform, and everything to do with who will land the choice job as head of a single Palestinian security force.

But the main reason for disbelieving in change, say Palestinians, is that Mr Sharon's policies preclude meaningful reform, no matter how much he presents it as a condition for talks. Many Palestinians quietly acknowledge that Israel's offensive was a defeat for their strategy of armed struggle, and a victory for Mr Sharon's vision of long-term, interim occupation. Mr Sharon has re-established Israel's untrammelled military rule of the West Bank, enabling his soldiers to enter Palestinian areas at will and to lay siege to the rest.

There is no sign that this will change. At a recent meeting with international donors and diplomats, the Israeli army laid down its new order in the West Bank. The Palestinian cities would remain permanently closed, and no Palestinian would be allowed to travel between them, other than through a rigorous pass system. Goods would be ferried through eight crossing points in a “back-to-back” system, under which supplies unloaded from Israeli trucks are transferred to Palestinian ones, at a massive rise in cost and time.

But the main reason for disbelieving in change, say Palestinians, is that Mr Sharon's policies preclude meaningful reform

The outsiders at the meeting pointed out that such measures will aggravate the West Bank's economic and humanitarian crisis. They also make a mockery of any attempt to establish a functioning Palestinian police force. Israeli officers shrugged their shoulders. But if this is the future, reform is not going to work. It becomes, argued one analyst, a condition that cannot be fulfilled, winding up like the “six days of quiet” that Mr Sharon once specified must precede negotiations for a ceasefire. And, he predicted, it is likely to be met with the same violent Palestinian response.

After the Tel Aviv suicide bomb, Mr Arafat rounded up 23 Hamas men in Gaza, allegedly because the bomber had come from there. The arrests were arbitrary, and were received with contempt by Palestinians, including Hamas leaders, who were busy laying mined defences in anticipation of an Israeli invasion, readying hospitals and supplying extra food to those too poor to supply their own. In Gaza such responsibility is appreciated, as is the political message that accompanies it: freedom from occupation first, then reform.

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Israel's Likud party

The sniper is now sniped at

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From The Economist print edition

A bid to do down Ariel Sharon from the right may have boomeranged

Reuters

Sharon could have the last laugh

WHEN George Bush called Ariel Sharon “a man of peace” last month, many rolled their eyes. But this week, Israel's prime minister was battling inside his hardline Likud party for the principle of Palestinian statehood—and may well come out the winner.

It is true that the fragmented and truncated state that Mr Sharon says he might, perhaps, one day offer to a “reformed and transparent” Palestinian Authority is one that no Palestinian would accept. Nevertheless, by fighting off his outflankers on the right, Mr Sharon has kept alive the prospect of a regional peace conference. The Americans and others are hoping that a dynamic might be started there that could influence Mr Sharon to change his views—or influence the Israelis to change Mr Sharon.

The first round of the fight seemed to go to Mr Sharon's rival, the former and would-be-future prime minister, Binyamin Netanyahu. On May 12th, the Likud central committee rejected, by 669 votes to 465, Mr Sharon's request that a motion from the Netanyahu camp opposing Palestinian statehood be deferred. Mr Sharon stormed out of the hall, accompanied by catcalls. The committee went on to affirm by acclamation its opposition to “any Palestinian state west of the River Jordan”.

But next day a much revived Mr Sharon, his voice dripping with sarcasm, his face carefully made up for the television cameras, reminded the party's parliamentary faction that he had been elected to office by the direct vote of 62% of Israelis. Policy, he said, would be made by him, not by “political machinations”. The next election, he added confidently, would be held in November 2003, at the end of the present parliamentary term, and not a day before.

Mr Netanyahu huffed about the central committee being the voice of the people. But on May 14th an opinion poll in the mass-circulation *Yedioth Ahronoth* found Mr Sharon streets ahead of Mr Netanyahu among the people who matter, the 150,000 Likud rank-and-file who elect the party leader. Dissection of the central committee vote found a disproportionate attendance of settlers and old-time backwoodsmen. Other members seem to prefer Mr Sharon's line, and do not like seeing their prime minister publicly embarrassed.

Political observers felt that neither man had emerged strengthened, but that Mr Netanyahu's discomfiture might prove the more lasting. He had painted himself into the extremist corner. Ironically, Mr Sharon, who spent much of the past 20 years sniping from the right at Likud prime ministers, among them Mr Netanyahu, has now won points for statesmanship, and sympathy for being sniped at. His government's longevity, which Mr Netanyahu was presumably trying to reduce, may even have been enhanced by the Likud infighting.

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Iraqi sanctions

Cosmetic surgery

May 16th 2002 | CAIRO
From The Economist print edition

Easing sanctions ends a UN squabble but will not greatly affect Iraq

Get article background

TWELVE years after being imposed, the siege of Iraq is set to ease, a little. New rules passed on May 14th by the UN Security Council, allowing the country to import a broader range of goods with less fuss, are intended to improve the sorry lot of ordinary Iraqis—and shift blame for the country's misery away from Iraq's besiegers to the man who holds the keys to the castle, Saddam Hussein.

Letting a few more lorries rumble into Baghdad does not mean an end to the blockade. Iraq has still not convinced the rest of the world that it is free of weapons of mass destruction, and America is still threatening to force a “regime change” on the country. The UN controls all of Iraq's legal export revenues. It does not allow the foreign private investment that would enable Iraq to start rebuilding its shattered industry, agriculture and sanitation system. And it prohibits the spending of hard-currency earnings on local goods and services. This perpetuates Iraq's dependence on state-rationed imports, and—since oil earnings cannot be used to pay government salaries—leaves its teachers, doctors and nurses short of a living wage. Yet the new reforms represent the biggest overhaul of sanctions since 1996, when Iraq was allowed to resume selling oil.

The UN's oil-for-food programme has succeeded in stopping a precipitous plunge in living standards, stabilising Iraqi incomes at around a quarter of their pre-war level. However, its procedures have proved so cumbersome that it takes between six months and a year for an average shipment to make it into the country. Some $5.3 billion in orders have been frozen because of American and British fears that they might serve some military purpose. In all, the $54 billion-worth of oil sold under oil-for-food has translated into less than $20 billion-worth of goods arriving in Iraq. This amounts to a meagre 41 cents a day per person, hardly enough to mend the country's broken infrastructure and restore its people's quality of life.

Under the new rules Iraq will still have to place all its oil earnings under UN control. Cash will still be siphoned to pay reparations for the Gulf war, joining the $15 billion diverted so far. But whereas import contracts for virtually everything but food and drugs had previously to be vetted by a dawdling sanctions committee, the onus of blocking “dual use” items is now placed on independent UN agencies.

Anything that is not on a Goods Review List should now, in theory, be passed automatically within ten days. Although the list is 332 pages long, it is slightly less daunting than this length suggests, consisting mostly of components for weapons, military communications, and stuff Iraq would not want anyhow, such as underwater robots.

Iraqi shoppers, skinned by the black-market prices demanded for household goods, will be relieved to find more variety and better prices. Countries that Iraq has courted through trade will also be pleased. Russia stands to scoop some $750m from deals that America is said to have now promised to unblock. Arab countries, some 13 of which have either signed or are actively negotiating free-trade agreements with Iraq, will also be hoping to cash in.

Their optimism may be premature. The long squeeze on investment in Iraqi oilfields has kept its production capacity far below the potential of a country with the world's second largest oil reserves. Mr Hussein's brash politicking has been expensive, too. His month-long suspension of oil sales, called in April to protest at Israel's invasion of Palestinian cities, cost the country $1.2 billion. Partly as a result, the current six-month phase of the oil-for-food programme, which ends on May 30th, is suffering a $3 billion shortfall in cash to pay for approved contracts. Just clearing this backlog will take months.

The Security Council passed Resolution 1409 unanimously. Even Syria, a temporary council member which happens to pocket a tidy income from smuggling Iraqi oil, voted in favour, albeit after the usual harrumphing about the double standards it accuses the UN of applying to Israel. The vote ended nearly two years of wrangling between America and Britain and the other three permanent members. The former were forced to dump provisions that would have clamped tighter inspections on Iraq's borders, but even the watered-down “smart” sanctions seem to endorse the view that Iraq remains a danger to world peace.

Iraq has described the measures as a “new harassment”. But, under the threat of American assault, the regime has been cooling its language. The newspapers have taken to calling for dialogue with America and Britain. In talks with Kofi Annan, the UN's secretary-general, a third round of which is slated for later this month, Iraqi negotiators have hinted, ever so slightly, that a return of the weapons inspectors may be on the cards.

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Sierra Leone's election

After the horror, a new beginning

May 16th 2002 | FREETOWN
From The Economist print edition

Sierra Leone is no longer the worst place on earth to live

Get article background

EPA

Voting for peace

AMPUTEES can be surprisingly good at soccer. The ones at Freetown's amputee camp twist, dribble and shoot, careful all the while not to tap the ball with their crutches, which is against the rules. After a decade of civil war, so many people in Sierra Leone have lost limbs to mortars, machetes or polio that Ibrahim Touré, captain of the team, dreams of a national amputees' cup.

This small west African country has been formally at peace for only four months. Its civil war was so barbaric, and the injuries it left so grave, that a swift return to normality is out of the question. But Sierra Leoneans are doing their best. On May 14th, they held an election for parliament and the presidency in an atmosphere of near-miraculous calm. Eager crowds gathered outside polling stations before dawn, long before they opened. Rural voters walked for miles to the nearest booth, with children on their backs and registration cards in their hands. Where there was no building, cardboard booths were erected under trees. Some irregularities were reported, but these were ascribed to incompetence rather than fraud.

Nine candidates ran for president. The incumbent, Ahmed Tejan Kabbah, who campaigned with the slogan “Di war don don” (the war is over), is likely to win, possibly in the first round. Foday Sankoh, leader of the Revolutionary United Front (RUF), the rebel group that spent the past 11 years gouging out eyes, slicing off hands and buttocks and skinning people alive, was not allowed to stand because he failed to register as a voter. This was not surprising, as he has been in jail for two years on multiple murder charges, and has reportedly lost his senses.

In his place, a charmless former academic, Pallo Bangura, represented the RUFP, the RUF's political reincarnation, but was not expected to do well, except perhaps in traditional rebel strongholds. Another candidate, Johnny-Paul Koroma, who led a military coup in 1997, hinted that he might take up arms again if he lost, but opposition to the government is more likely to be expressed in parliament. A new party called the Movement for Progress, led by a former human-rights activist, hopes to keep the next government under close scrutiny.

Whoever wins, rebuilding Sierra Leone will be a mammoth task. The war left at least 45,000 dead and forced perhaps 1m to flee their homes. Both sides tortured, pillaged and raped. Now that the fighting has ended, the 65,000 rebels and pro-government militiamen who have surrendered their weapons must somehow be reintegrated into society.

This is going surprisingly well. When they handed over their guns, the ex-fighters each received a lump sum of 300,000 leones ($150) to help them subsist for a few months. About 33,000 have now signed up for a programme that offers more cash, help with starting small businesses, and training in marketable skills such as carpentry or hair-cutting. Unfortunately, the programme is running out of money. And even if donors open their wallets again, it is unlikely that all the newly trained carpenters will prosper. Jobs are hard to come by, and ex-fighters may be tempted to go back to living by looting.

The hardest cases are the child soldiers, whom the RUF recruited at gunpoint, kept loyal with drugs and sometimes forced to murder their own parents. Families, villages and schools are often reluctant to welcome them home again. But with the help of charities, such as UNICEF, over 3,000 children have been reunited with their families, in the Freetown area alone, and most are apparently coping.

Convinced that the fighting is over, Sierra Leonean refugees are at last returning home: in the past 18 months, 160,000 have trudged back from neighbouring Liberia and Guinea. The lucky ones carry plastic sheets and two months' rations, supplied by the UN. Many of the rest have nothing, and return to villages burnt and emptied during the war. Tens of thousands are crippled. Sahr Tarawallie, for instance, lost most of his right leg in an ambush, and two of his children, who fled in the confusion. Today, he lives in a camp for amputees. Despite his handicap, he found a job as a switchboard operator, and two years ago, the Red Cross managed to trace his daughter. His elder son is still missing.

Once the electoral euphoria subsides, reality will bite. Last year, the UN rated Sierra Leone the worst place on earth to live. Peace alters that, of course, but the next few months will be particularly difficult: with the rainy season approaching, returnees will have no time to start planting their rice and cassava, so few will produce much food this year. More happily, the World Bank predicts that the economy will grow by 7-8% this year, albeit from a dismally low base.

Once the electoral euphoria subsides, reality will bite

The country's diamonds, which financed the rebels' war, could now provide jobs and tax revenues. According to a recent study, diamond exports could, with enough investment, more than triple over the next four years, to $180m. Sierra Leone also has one of the world's richest deposits of rutile, a mineral used in paint, which should be mined again next year. A fairly stable macroeconomic situation helps: inflation is negative and almost 90% of the country's foreign debt has been forgiven.

Outsiders have helped, too. The UN has 17,500 peacekeepers in Sierra Leone, who report that all parts of the country are now under control. Driving outside Freetown is not the life-or-death lottery it once was, although the potholes still gape. Donors paid for the election, and helped organise it. A British civil servant is in charge of the police, and British officers are training the Sierra Leonean army. Unfortunately, as the country becomes more stable, emergency aid is drying up. Various UN agencies say they need three times as much cash as they have received for development projects, and the World Food Programme says it will have to reduce the amount of food it hands out in July for lack of funds. A special court for war crimes has now received enough contributions to cover the first year of hearings, but the country's “truth and reconciliation commission”, which is supposed to start work in the next few weeks, has no money at all.

AP

A happier future?

If donors do rally round, they will have to be careful that their money is not filched. Sierra Leone was getting poorer each year even before the war, largely because of mismanagement and corruption. Average incomes peaked in 1970, and dropped by over a third during the two decades before the fighting began. The RUF's pretext for revolution, that the governing class were crooks, was quite true.

To forestall another war, they should change their ways. An anti-corruption commission has been set up, and posters around the country even promote an anti-corruption hotline, but critics suspect that most prosecutions are politically motivated. Even the National Electoral Commission has been tarred by allegations of sleaze, and unpaid teachers and doctors often ask for money to provide what is supposed to be a free public service.

Ultimately, Sierra Leone's fate cannot be untangled from that of its neighbours, who are a rotten bunch. Liberia's president, Charles Taylor, who is accused of having supplied the RUF with weapons in exchange for diamonds, is mercifully weakened by a UN embargo. He also faces rebels at home, who marched close to his capital this week. Instead of exporting refugees, Sierra Leone now imports them from Liberia: 30,000 so far, says the UN.

Meanwhile, on Freetown's Lumley beach, dozens of people congregate every Sunday to frolic in the waves, pummel volleyballs and slurp beers at one of the many bars that punctuate the long stretch of pristine white sand. Life guards in yellow T-shirts keep watch. A tourist booth displays old leaflets advertising “Africa's paradise”. The waltz of UN military helicopters mars the idyll, and it is hard to imagine tourists stampeding to Freetown, but the scene is a reminder that Sierra Leone was once a pleasant place, and could be again.

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Rwanda's gorillas

Poachers' return

May 16th 2002 | KIGALI
From The Economist print edition

The high price of a baby

FOR the first time since 1985, poachers are again trafficking in Rwanda's treasured mountain gorillas, of which only 650 remain in the world. Last week they killed two female gorillas in order to seize their infants. They made off with one baby, but a second was left behind, probably after an adult male intervened to save it.

Wildlife groups say that an infant gorilla can fetch as much as $125,000 on the black market. But the current regime, unlike some of its predecessors, has always considered that the long-term benefits of gorilla tourism far outweigh quick short-term profits.

So far the calculation has paid off and gorilla tourism ranks as Rwanda's third foreign-currency earner. Tourists flock here to pay $250 for an hour tracking the animals on all fours through dense undergrowth. Without exception, they return enchanted.

It was the late Dian Fossey, an American primatologist, who in the 1970s and early 1980s brought mountain gorillas to the attention of the general public. But in 1985 she was hacked to death, probably by one of the poachers she had fought against.

The mountain gorilla is a critically endangered species and all forms of trade in the animals are internationally banned. In Congo-Brazzaville and Cameroon, where the more prolific western lowland gorilla is found, gorillas are regularly eaten. But farther east, eating primates is taboo.

The only reported incident of mountain gorillas being eaten happened last year when starving Rwandan rebels killed two animals and roasted them to eat the meat. Innocent, a young militiaman, was so terrified by the sight that he surrendered to the Rwandan army. “When I saw them eat that old man, I thought what's to stop them from eating me too,” he confided in a whisper.

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The Dutch general election

A wind of change in the Netherlands—and across Europe

May 16th 2002 | ROTTERDAM
From The Economist print edition

The Fortuyn phenomenon confirms a wider drift to the right in Europe

AP

PIM FORTUYN did not live to see the full extent of the upheaval he caused. But in the Dutch elections on May 15th his Pim Fortuyn List, which did not exist three months ago, became the second-largest party in parliament, with 26 seats. It was a personal vehicle of Fortuyn, an anti-immigration, establishment-bashing populist, assassinated on May 6th. His legacy is a marked shift in the political debate in the Netherlands—and maybe in Europe too.

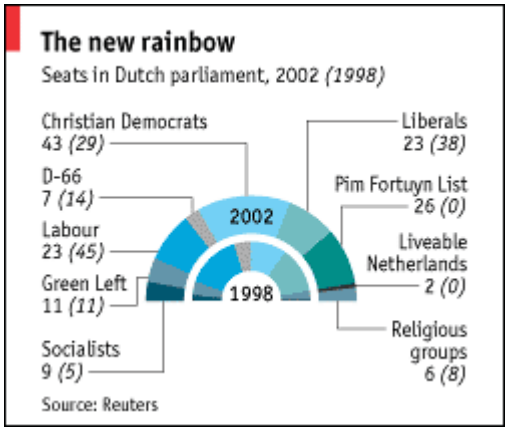
Dutch politics, which has long been dominated by consensual coalitions run by technocrats with a wide outlook abroad and a tolerance of multiculturalism at home, will probably now have to incorporate a batch of novices with a strong nationalist distaste for immigration and Islam, who are against multiculturalism and loth to endorse faster integration within the European Union.

The Dutch proportional voting system means that Dutch governments are almost sure to be coalitions. The Fortuyn List is now likely to join a centre-right government led by the Christian Democrats, who, after an unusual eight years out of office, bounced back to become parliament's largest party, with 44 seats. Their leader and almost certainly the next Dutch prime minister is Jan Peter Balkenende, a 46-year-old former academic who bears a remarkable resemblance to Harry Potter.

Unlike the leaders of the Labour and Liberal parties, which did badly, Mr Balkenende never snubbed or demonised Mr Fortuyn. Indeed, he shared notable parts of his agenda. In a speech earlier this year, Mr Balkenende repudiated the country's multicultural approach to immigration and said newcomers should assimilate with Dutch culture. That, says a senior diplomat in The Hague, marked “a 180 degree shift by the Christian Democrats.”

Coalition building after a Dutch election often takes months. This time, however, politicians will want to move fast to try to restore stability to a system rocked by the Fortuyn phenomenon. Efforts to form a coalition will be complicated, however, by the fact that Fortuyn's followers had not elected a successor to replace him in the days before the election—and had already begun to bicker. On May 16th the party chose Mat Herben, a former journalist, as its new leader.

Some Christian Democrats may still shy away from trying to forge a coalition with the Fortuyn bunch. On paper at least, there are other options. Mr Balkenende could try to build a centre-left coalition with the Greens and Labour or a “grand coalition” of the centre that would embrace Labour and the Liberals, who are on the right in economics.



But Dutch politicians are worried that the new populist strain in their country's politics would only be nourished if the establishment parties seemed to gang up on the Fortuyn List despite the voters' clear swing to the right. So the Labour Party, which has led a coalition government for the past eight years, will go into opposition after recording its worst electoral performance since 1945. Its leader, Ad Melkert, has already resigned.

A pattern may now be emerging across the EU. Centre-left and social democratic governments are losing power to centre-right governments. In the past year, the left has lost power in Italy, Denmark, Portugal and now the Netherlands. In France, the Socialists' candidate failed to reach the final round of the presidential election. In Germany, Gerhard Schröder, the Social Democratic chancellor, is in danger of losing a general election in September.

Political parties that campaign against immigration are doing better. The admission of Jörg Haider's Freedom Party into a ruling coalition in Austria in 2000 was widely considered a dangerous aberration. But anti-immigration parties have since broken into government in Italy and now, it seems likely, the Netherlands. The Danes' right-wing government depends on the votes of a far-right party. France's National Front is on the rise.

It is not just immigrants and would-be asylum-seekers who have cause for alarm. The EU itself may be rattled. Mr Balkenende, the Fortuyn people and Hans Dijkstal, leader of the Dutch Liberals, who would be the third party in a centre-right coalition government, have all cast doubt on the wisdom of rapidly enlarging the EU to include as many as ten more countries, mainly in Central Europe, which is meant to be agreed this year. If even the impeccably pro-European Dutch get cold feet, foes of enlargement, notably the French, may be emboldened. These new centre-right governments are chillier, too, about faster European integration. That will be awkward for the keen Euro-federalists packed into the grand convention on Europe's future now under way in Brussels.

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France's president

Fresh momentum

May 16th 2002 | PARIS
From The Economist print edition

France's newly elected president is demonstrating his political dexterity

Get article background

BOTH scenes had an obvious similarity: last October, when France and Algeria met in Paris's Stade de France for a “friendly” soccer match, French fans of North African origin booed the national anthem, the Marseillaise, and later forced the match to be abandoned by invading the pitch. Last weekend, in the same stadium, Corsica's Bastia met Brittany's Lorient in the French cup-final—and the Corsican fans greeted the Marseillaise with a barrage of whistles and jeers.

And now the big difference. In October, the then prime minister, Lionel Jospin, remained in stony-faced silence even as the crowd threw bottles at two of his ministers, both women. By contrast, last weekend, Jacques Chirac, newly re-elected as president on May 5th, refused to go on the pitch to greet the players, demanded—and got—an apology to the nation from the boss of French soccer, and delayed the match for 20 minutes while he stalked off to address the TV cameras. “I won't tolerate the undermining of the values of the Republic or those who express them,” he told the watching millions.

No wonder Mr Jospin, the Socialists' presidential candidate, has been voted away into political retirement after being knocked out in last month's first round of the contest. Somehow, Mr Chirac has the ability to seize the moment. As Dominique Voynet, leader of the Greens and formerly Mr Jospin's environment minister, said grudgingly of Mr Chirac's reaction: “It was overplayed—but well played.”

Certainly well enough to boost the right's momentum and its confidence that in the two-round general election due on June 9th and 16th it will win a majority in the National Assembly. That would avenge the right's defeat of 1997 and so let its president avoid a repetition of the five-year “cohabitation” he has just endured with the left.

The challenge for Mr Chirac is to maintain that momentum. On May 6th he appointed a new prime minister, Jean-Pierre Raffarin, who is supposed to be “close to the people” and thus hard for the left to attack. On May 7th came an interim government chosen from across the moderate right and with an explicit instruction to get a move on—especially by cracking down on crime and vandalism, issues that helped persuade almost a fifth of the electorate to vote for the extreme right's Jean-Marie Le Pen as president. On May 11th the new Union for the Presidential Majority (UMP), an expedient amalgam of most of the parties of the centre and right, issued a list of its agreed candidates for the assembly's 577 constituencies. On May 14th it updated its list from 523 candidates to 533. This meant that only 44 constituencies had been left for that part of the centrist Union for French Democracy (UDF), led by François Bayrou, which has refused to surrender its independence to the UMP.

Can anything stop the Chirac steamroller gathering pace? The left, demoralised by the elimination of Mr Jospin in the first round of presidential voting, is struggling to unite its various components—Socialists, Greens, Communists and so on—under François Hollande, first secretary of the Socialist Party. In the process the Socialists, who held 248 seats in the outgoing parliament, are moving leftwards, forswearing all privatisation and deregulation.

One problem for Mr Hollande is that Jean-Pierre Chevènement, once one of Mr Jospin's ministers, has been playing hard to get, even threatening to present 400 candidates advocating a theme of a centralised Republic that could appeal to old-guard nationalists of both left and right. A bigger problem is that the left will be trying to tell the voters that cohabitation is good for them, even though they had earlier said exactly the opposite; Mr Jospin's chief adviser, Olivier Schrameck, published a book last October saying that there was “no worse situation for our country”. The left argues that this would be a

new kind of cohabitation, since Mr Chirac was elected president with 82% of the votes only because left-wing voters had made common cause with the right against Mr Le Pen. Yet the voters may well reckon that the argument smacks of sophistry.

In the end, Mr Chirac and his allies may fear Mr Le Pen's National Front more than it worries about a revitalised left. After his defeat an unabashed Mr Le Pen declared that some 237 of his candidates in the general election's first round should get the 12.5% or more of the vote needed to proceed into a second and final round against opponents from the right and left. In such triangular contests the Front might take enough votes from Mr Chirac's camp to deliver victory to the left. This explains rumours that the right is conspiring to split the extreme-right vote by secretly boosting the prospects of the National Republican Movement of Bruno Mégret, a former follower of Mr Le Pen turned rival.

In the meantime, Mr Chirac is promising the voters all they could reasonably desire, and then some: lower taxes, better state services, better pensions, more jobs and so on and on. The trouble is that the price tag over five years adds up to *euro*30 billion ($27 billion), enough to make it impossible for France, whose budget deficit this year is forecast to be at least 1.9% of GDP, to balance the budget by 2004 in accordance with the euro-zone's stability and growth pact. Indeed, Mr Chirac, despite reaffirming the 2004 date as recently as March at an EU summit in Barcelona, has let it be known that 2007 is more realistic.

Mr Chirac is promising the voters all they could reasonably desire, and then some

How to wriggle off the EU hook? The answer is to cosy up to other budget-challenged euro-zone countries, especially Germany, which hardly wants to cut its spending ahead of its own general election in September. Will such a Franco-German alliance alarm the powers-that-be in Brussels? Of course, but Mr Chirac will consider that an electoral plus. Mr Le Pen's anti-European rantings showed that there are plenty of votes to be won in France by tweaking the EU's authority.

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Football

Foul play

May 16th 2002 | BRUSSELS
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The World Cup starts with football's boss already in a shoot-out

Reuters

Still no red card for Blatter

AS THE final whistle approaches, the tension in a close football match always rises. The same goes for the power struggle in FIFA, football's world governing body. On May 29th, two days before the World Cup kicks off, FIFA, which is based in Switzerland, will elect its president for the next four years. Sepp Blatter, the body's 66-year-old president, is standing for re-election against Issa Hayatou, the Cameroonian head of Africa's football federation.

But Mr Blatter's campaign has been hurt by allegations of corruption and mismanagement made by Michel Zen-Ruffinen, who as general secretary is FIFA's second most senior official. In a 21-page dossier, with 300 pages of evidence, Mr Zen-Ruffinen says that his boss has made all manner of mysterious and unauthorised payments to football officials around the world, as well as awarding television contracts to under-bidders. These charges have provoked 11 members of FIFA's 24-man executive committee to file a formal complaint against Mr Blatter in the Swiss courts.

In most big organisations, a president facing an internal revolt amid accusations of corruption would step down, at least temporarily. His chances of being voted back into office would be slim. But FIFA is no normal outfit. When its congress meets in South Korea, the vote will be decided by a college of electors made up of 204 national football federations, each with one vote cast in secret. So Germany or France have no more votes than the Solomon Islands or Trinidad. This is the key to Mr Blatter's power. Thanks to his skilful use of patronage, much of FIFA's electorate plainly has an obligation to him. Indeed, Mr Zen-Ruffinen says that Mr Blatter has consistently channelled FIFA cash to people and organisations that may help re-elect him.

Still, FIFA cannot be accused of doing nothing to address the charges against its president. This week it declared that an emergency committee (packed with Blatter loyalists) had relieved Mr Zen-Ruffinen of all responsibility for financial matters and barred him from speaking to the press. Mr Blatter could still win his re-election shoot-out.

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The Mafia

Cosy comfort for Cosa Nostra

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From The Economist print edition

Despite big setbacks in the past decade, the Mafia is still far from beaten

TO REMARKABLY little fanfare in the national press, a Sicilian judge has ruled that there are no grounds, following judicial investigations that had been carried out between July 1998 and July 2000, for charging Silvio Berlusconi, Italy's prime minister, and Marcello Dell'Utri, a senator in Mr Berlusconi's right-wing Forza Italia party, with complicity in the murder ten years ago of the country's two top anti-Mafia magistrates, Giovanni Falcone and Paolo Borsellino, and their escorts. Instead, at the request of the magistrate who had been investigating those spectacular allegations against the two politicians by *pentiti* (repentant mafiosi), the judge in the Sicilian town of Caltanissetta agreed that the matter should be closed.

At the same time, however, Mr Dell'Utri, a close friend of the prime minister, remains on trial in Palermo, Sicily's capital, for collusion with the Mafia. The trial started four-and-a-half years ago. A verdict is expected by the end of the year. Palermo's appeal court should also soon decide on the prosecution's appeal against the verdict of not guilty given to Giulio Andreotti, seven times prime minister in the 1970s and 1980s, who was charged in 1995 with colluding with the Mafia. Such lethargy alone is proof that Italy's justice system needs drastic reform.

Caltanissetta's court has been the scene of several large trials of mafiosi who have now been convicted of murdering Falcone on the road from Palermo's airport to the capital in May 1992 and of killing Borsellino in a city suburb two months later. In February and March this year, an appeal court confirmed life sentences on 24 mafiosi for involvement in Borsellino's murder.

Though many bosses and their minions are now in jail, other recent judicial proceedings suggest that the Mafia is still far from beaten—and continues to have political friends. The idea that the Mafia is on the run is nonsense, says Domenico Gozzo, a Palermo magistrate. No part of Sicily is free of its blight. The Sicilian capital remains one of the worst affected places. Trapani, in the island's west, is particularly bad. Mafia families still keep a firm grip on their districts, mainly through extortion, explains Mr Gozzo.

Protection rackets remain common. For instance, in the infamously bloody town of Gela, on the south coast, they are the main form of crime, says its deputy police chief. A recent survey there found that young people mainly blame the Mafia for high unemployment and cite the *pizzo* (extortion payment) as the main reason they would not consider starting a business. Extracting information from victims is hard, says the policeman, though new technology and local knowledge provide a good idea of how local Mafia families are run.

Magistrates in Palermo are less sanguine. Although the Mafia was put on the defensive after the murders of Falcone and Borsellino, which caused an unprecedented wave of popular revulsion, it has regrouped and changed in a way that makes the law's job harder. The flow of talkative *pentiti* has dried up. Though the number of murders in Palermo's judicial district rose sharply last year to 155, the bloodshed has made few headlines. The Mafia is keeping its head down. “We no longer know how families are connected,” says Mr Gozzo. “There's a cut-out between those giving and those carrying out orders. The Mafia seems to be working in cells that don't know each other, like terrorists.”

“The Mafia seems to be working in cells that don't know each other, like terrorists”

Cosa Nostra (“Our Thing”, as the Mafia is often called) has also changed how it handles its enormous, ill-gotten wealth. Between 1993 and 2000, Palermo's court sequestered assets totalling 10 trillion lire ($5.8 billion). The Mafia has taken measures to limit such losses, reducing its investment in property and diversifying into other assets. It also uses fronts from outside family circles to hold assets, gets expert financial advice on how to camouflage cash transactions, and has invested more abroad. Confiscation is a key part of the fight against the Mafia, says Elio Collova, a court-appointed administrator of Mafia assets. But a legislative overhaul under way in the last parliament to make procedures more effective has stalled.

Worse, more recent legislative proposals may even make the Mafia's life easier. One would reduce the maximum prison term for fraudulent bankruptcy, thereby making it impossible to tap suspects' telephones because investigating magistrates can do so only for serious crimes that carry long sentences. Another proposal would remove from magistrates the job of co-ordinating investigations and give politicians a much bigger say in the process.

Many people fighting the outfit also say that the current barrage of attacks by ministers on magistrates (for their alleged incompetence, arrogance and left-wing bias, among other complaints) gives succour to organised criminals. “Such interventions may mean little to magistrates in Turin [in the north-west of Italy] but they mean a lot in Sicily because they tell the Mafia that the state isn't behind us,” says Mr Gozzo, who has been prosecuting Mr Dell'Utri for alleged association with the Mafia.

So Cosa Nostra is in fair shape. It is certainly looking forward to an expected inflow of EU cash to help poor Sicily. And it relishes the prospect of the bridge due to be built between Sicily and mainland Italy: the Mafia still invariably gets involved in construction projects.

A brave band of investigators and magistrates battles on. But many of them feel lonely and vulnerable. Anna Maria Palma, a magistrate and friend of Borsellino who helped prosecute his killers in Caltanissetta, regrets how little respect the anti-Mafia campaigners now get. “It's very sad,” she says, “but most people have forgotten the sacrifices made by Falcone and Borsellino.”

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Spain, Britain and Gibraltar

Crunchy

May 16th 2002 | MADRID
From The Economist print edition

The two countries want a deal. The people of the colony do not

IT MAY be crunch time in negotiations to settle the dispute between Britain and Spain over Gibraltar, the tiny British colony at the southern tip of Spain ceded to Britain by treaty in 1713. The summer deadline, set when talks began in earnest last autumn, is near. Spain's prime minister, Jose Maria Aznar, and Britain's Tony Blair, hoped an agreement might be ready this week, to be unveiled before they meet on May 20th. Instead the talks are at breaking point.

The stumbling block is control over the naval base and military airfield which together account for 40% of Gibraltar's territory and provide important support at the gateway to the Mediterranean. American and other NATO vessels and aircraft use them. Britain, backed by the United States, wants to keep them. Spain is willing to concede operational control but insists that its right to sovereignty over the base area, as well as the rest of Gibraltar, must be recognised.

Britain sees the principle of shared sovereignty as the definitive solution. But Spain, its prickly national pride at stake, refuses to drop its historic claim to outright ownership of the Rock, especially after Britain's qualms over relinquishing control over the base were recently made public by the defence secretary, Geoff Hoon.

After the Spanish and British foreign ministers met this week, a face-saving compromise was said still to be possible. Spain might, for instance, be willing to soften its stand on sovereignty in return for access to the base. Ideally it would want joint use along similar lines to its agreement with the United States over two military bases in southern Spain. But that might prove unacceptable to the 30,000 Gibraltarians, whose wishes Britain pledged to respect under the colony's current constitution of 1969.

When he visited Gibraltar earlier this month, Britain's foreign secretary, Jack Straw, was greeted with cries of “Judas” as he tried to persuade people there that an agreement would be in their long-term interest. Mr Aznar, meanwhile, confided to journalists that ultimately, yes, of course, he wanted Gibraltar to be Spanish. The Gibraltarians could choose whatever nationality they wanted, he added. What they could not have, he insisted, is the right to settle the territory's future. He fears that would set a precedent for self-determination that Catalans, Basques and others would quickly want to emulate.

So, while Britain wants a definitive deal, Spain implies it could be just a stepping stone to something more, however distant—which is anathema to the Gibraltarians. No wonder both sides fear that their rapprochement could fizzle.

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Portugal

The smack of firm government

May 16th 2002 | LISBON
From The Economist print edition

A painful but necessary budget

EPA

THE new centre-right prime minister of Portugal, Jose Manuel Durao Barroso, expected to be unpopular, at least to begin with. Reining in public finances and tackling vested interests, as he promised to do on the stump for the March election, was unlikely to endear him to the country. Since taking office a month ago, he appears to have done everything possible to fulfil his own gloomy forecast.

In a revised budget for 2002, approved in parliament this week, he proved even tougher than his election campaign had threatened. The main rate of value-added tax (VAT), which he had undertaken not to raise, went up from 17% to 19%. A promised “fiscal shock”, designed to stimulate economic growth by cutting corporate tax from 30% to 20% and lowering the top rate of income tax, has been postponed. For good measure, state-subsidised mortgage rates for house-buyers are to be abolished, civil-service recruitment frozen and more than 70 state bodies closed down or merged. Local authorities are being barred from running up debt, provoking wrath among the prime minister's own Social Democrats.

Protesters are already taking to the streets. State television, with debts of almost *euro*1.5 billion ($1.4 billion), is widely covering demonstrations by its own workers against government plans to scale back its operations. Trade unions are planning a one-day general strike against proposals for more private-sector involvement in social security, pensions in particular.

Despite all this, Mr Durao Barroso's popularity ratings have gone up. A poll of businessmen shows strong support for his economic programme. The protests may be a sign that necessary reforms are at last being attempted. Manuela Ferreira Leite, the new finance minister, already known as “the iron lady”, says that overestimates of tax revenue and underestimates of public spending by the previous Socialist government would have pushed the deficit up to 4.5% of GDP this year. Her cuts should bring it down to 2.8%, just within the 3% limit set by the euro-zone's growth and stability pact. Unless it keeps within that limit, Portugal risks being barred from applying for more aid from the “cohesion fund” for the EU's four poorest countries. That, she says, could “devastate” the economy. France and Germany may be able to thumb their noses at the 3% ruling, but little Portugal dares not risk it.

The European Commission, which wants all euro-zone countries to move fast towards balancing their budgets in 2004, expects Portugal's government to get even tougher next year. Mr Durao Barroso may well hope that France and Germany will eventually succeed in pushing back the zero-deficit deadline. Until then, he is unlikely to take further risks of damaging his popularity.

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Turkey's media law

A backward step

May 16th 2002 | ANKARA
From The Economist print edition

New restrictions may make the press more pliable

“A DARK stain on Turkish democracy” is how Nuri Kayis, chairman of Turkey's broadcasting watchdog, described a new media law enacted this week by parliament. It will, among other things, let the media barons compete for lucrative government tenders and increase the number of television and radio stations each may own. With such inducements, it is no wonder that all of the big dailies and television channels have kept silent over the restrictions introduced by the law, which fly in the face of Turkey's efforts to join the EU.

For example, Internet service providers will in future have to submit pages to a magistrate for approval before putting them on the web. Similar rules that already apply to the printed media have been stiffened. Drastic new penalties have been imposed for violating broadcasting laws. And the 240-odd regional television channels and 1,200 radio stations, which on shoestring budgets serve as independent voices, will be even more vulnerable to collapse.

Mr Kayis accuses the government of trying to shift media attention away from corrupt politicians “to sensationalist trash and animal stories”. The new law will mean more government appointees on the board of his agency, further diluting its modest independence. The bans that the EU wants scrapped on broadcasting in the Kurdish language remain. Only the Islamist opposition, whose voice is stifled by the mainstream media, fought the bill in parliament.

Ahmet Necdet Sezer, Turkey's non-executive president, who is a former judge and has become a champion for human rights, listed ten constitutional violations when he vetoed the law last year. Having done so once, he cannot do so again. But he can apply to the Constitutional Court for its annulment. That could take years. Meanwhile, media magnates will be free to snap up government contracts and buy stakes in state companies earmarked for privatisation.

In exchange they may well be nicer to the politicians. When newspapers owned by Aydin Dogan, Turkey's most powerful media boss, began heaping praise on Mehmet Ali Bayar, a youngish spark who gave up a stellar diplomatic career last month to lead a small conservative party, Mesut Yilmaz, a deputy prime minister, remarked that the new media law, then in draft, might have to be tweaked. Mr Bayar was soon getting fewer column-inches.

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Poland's government

Gasping already

May 16th 2002 | WARSAW
From The Economist print edition

The honeymoon for the Polish government elected last autumn is over

Reuters

Dusty answers for Miller

COME spring, Polish workers tend to take their protests to the streets. This year, disgruntled nurses, teachers, miners, and shipyard workers have been descending on Warsaw, the capital. In one of the larger demonstrations, 70,000-odd Solidarity trade unionists surrounded the offices of Leszek Miller's Social Democratic government. Hotheads throwing eggs and smoke-bombs at Mr Miller's windows had to be restrained from breaking in. This week striking workers brought the port of Szczecin to a halt.

Conspicuous at the head of protests in the capital was Marian Krzaklewski, kingmaker of the previous centre-right government. Two years ago the incumbent president, Alexander Kwasniewski, a former communist like Mr Miller, politically annihilated him when he ran for the job. Mr Krzaklewski wants revenge. He hopes to use the trade union bit of Solidarity that he still runs as his weapon. Ominously for Mr Miller, Solidarity says it no longer wants to be part of government but will devote itself to getting better deals for its workers.

These have been a bad few months for Mr Miller's lot. Some 70% of Poles say his ministers are doing a bad job. His own popularity has plummeted. Foreign diplomats in Warsaw who had been admiring Mr Miller's apparently iron fists now fret that he is losing his grip. There is even talk of a split in the party between liberals, who look to Mr Kwasniewski, and Mr Miller's more backward-looking supporters. Mr Miller is still in charge and his views have moved a long way since the days when he was in the communists' ruling politburo. But the mere rumour of internal discord alarms a party that has long prided itself on its discipline.

Then there is unemployment. It is making even the most optimistic of Poles gloomy. Nearly 20% have no job. The rate rises to 40% among those between 15 and 24. A government scheme aimed at getting first-timers into jobs will not amount to much unless the economy begins to grow. It probably needs to do so at a rate of 5% a year if unemployment is to begin dropping. Not this year, then.

Mr Miller is in a bind. He would like to butter up his core constituency of ill-paid public-sector workers but paying them off would put him at odds with liberals, especially businessmen, in his own ranks. They want him to keep the budget tight, press on with revamping loss-making state industries (little sign of that to date), and rewrite the labour code to encourage entrepreneurs to hire new workers. Instead, Mr Miller may well fudge, rejecting strikers' demands when he can, paying them off when he cannot. That could be a recipe for political disaster. Mr Miller has staked his reputation on a Polish yes in a referendum within a year on whether to join the EU. If things continue to slide, voters might be tempted to say no.

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Charlemagne

Guido Westerwelle, hopeful liberal

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Might Germany's liberals hold the balance of power by the end of the year?

“A JOKE.” That was Gerhard Schröder's withering dismissal of Guido Westerwelle's announcement on May 12th that he would be seeking to displace him as chancellor in the general election in September. After all, Mr Westerwelle's liberal party, the Free Democrats, scraped up only 6% of votes cast in the last general election, and its leader has never been elected to any post, national or even local. Why should he be taken seriously when he says he aims to run the world's third economic power? In Germany, unlike in France, such things do not happen. Not since the German Republic's foundation in 1949 has anyone outside the two main party blocks had the nerve to pose as “chancellor candidate”. Mr Schröder's chuckle seems justified.

Best, though, not to laugh too loud. Jokes, gimmicks and publicity stunts are all part of the modern, dynamic Mr Westerwelle's stock in trade—but they have worked. He has certainly boosted the liberals' flagging fortunes since he took over as their leader last year. Of course he knows he has no chance of becoming the next chancellor. The post is not, in any event, directly elected, so calling oneself chancellor candidate does not mean all that much. But it puts down a marker along the road of Mr Westerwelle's planned transformation from a cliquish party identified with a professional elite into a more broadly-based “party of all the people” on a par with Germany's two main parties, the Social Democrats and the Christian Democrats. His conceit is also meant to fire the liberals' sense of independence at a time when their bigger rivals are eager to woo them as a potential coalition partner after September's election.

As things stand, the liberals could well end up deciding who should govern Germany next. That would not be for the first time. Until the collapse of Helmut Kohl's government in 1998, the liberals had been in power with various bigger partners for all but seven of the current republic's 49 years. But when Mr Schröder's Social Democrats took office, the liberals suddenly found their kingmaking role usurped by the Greens. Riven by infighting and shaken by a string of electoral setbacks, the liberals seemed to have run out of ideas and steam. By the end of 1999, they had seats in only four of federal Germany's 16 state parliaments. Some pollsters gave them only 4% of the national vote, well behind the Greens and even the ex-communist Democratic Socialists. Seats in the federal parliament are guaranteed with 5%. The liberals, it seemed, might die. No worry about that now.

It was the Christian Democrats' slush-fund scandal in 1999 that started the liberals' revival. Mr Westerwelle, a clever doctor of law who had been the party's general secretary, did not take over as leader from the amiable but dull Wolfgang Gerhardt until last May. Since then, though at first dismissed as a publicity-seeking if quick-witted lightweight, he has worked wonders. Aged 40, bouncy, unconventional, a confirmed bachelor, he has fizzed up what was a stodgy, middle-aged, male-dominated outfit and has widened its electoral appeal. In last month's election in the state of Saxony-Anhalt, one in ten blue-collar workers are reckoned to have voted for what once unblushingly described itself as the “party of the higher earners”.

Today, most pollsters give it some 10-13% of the national vote, almost twice as much as either the Greens or the ex-communists. Mr Westerwelle brazenly declares that his aim is to boost that to 18% by September. In the individual popularity stakes for politicians, he now comes seventh, level with Edmund Stoiber, the chancellor candidate for the Christian Democrats and their Bavarian sister party, the Christian Social Union. Half of all Germans apparently want him to play a bigger part in the future. And his party has at last begun notching up some notable successes, doubling its vote in state elections in Berlin and North Rhine-Westphalia (getting 10% in both states) and tripling its score last month to 13% in Saxony-Anhalt, in the former East Germany. The liberals are now in ruling coalitions in five states, four with the Christian

Today, most pollsters give the liberals some 10-13% of the national vote, almost twice as much as either the Greens or the

You don't have to make up your mind yet

Since the liberals have shared power on the national stage for nearly three decades with Christian Democrats, including 16 unbroken years under Mr Kohl, most Germans had come to associate them with the right. Mr Gerhardt accentuated that feeling. Mr Westerwelle has nudged the party back to the centre. He is refusing to pledge his troth to any of Germany's bigger beasts until after the election. It is the first time in decades that the liberals have not declared their coalition preference in advance. Mr Westerwelle says he could make a liaison with either Mr Schröder or Mr Stoiber. While he puts his party closer to Christian Democrats on economic matters, including labour-market reform, he sounds cosier with the Social kind of Democrats on such issues as immigration, human rights, genetic engineering and sexual and family values. Remember, the liberals happily helped run Germany alongside the Social Democrats for 13 years before ditching them in favour of Mr Kohl. They could rule with the left again.

So are Germany's liberals really liberal? By the American definition, hardly. Like his predecessors, Mr Westerwelle calls for less state interference, lower taxes, fewer subsidies, more privatisation, more individual choice and responsibility. But the bigger parties nowadays sing that tune too. True, Mr Westerwelle says he would slash public spending more ruthlessly, down to 33% of GDP—without saying how. He also wants to put income tax into three simpler bands of 35%, 25% and 15%, down from today's top rate of 48.5%. However, he says he shares Tony Blair's beliefs more than those of Margaret Thatcher or Ronald Reagan. “I'm a liberal, not an anarchist,” he says. And the joker in Germany's electoral pack? Maybe. Plainly Mr Schröder and Mr Stoiber would be unwise to laugh him off.

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Euro-referendum

Rushing towards Europe

May 16th 2002
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The chances of a referendum on euro-entry taking place are greater than most people believe, and growing

WILL we or won't we? Ask any Labour MP whether there will be a referendum on euro-entry and he will tell you that the chances have receded to much less than even. The Tory leadership has convinced itself that a referendum during this parliament (ie, before 2006) is only slightly more likely than England winning the World Cup. The same scepticism is apparent in the City, not only among those who tap their noses and claim to know the chancellor's mind, but also through the actions of currency dealers who would be marking sterling down if they really thought that euro entry was on the cards.

Last month's budget has hardened this conviction. The government is already being uncharacteristically bold in gambling that large tax-funded increases in spending would deliver a markedly better health service; is it really up for another, even bigger, risk? Economists also pointed out that a government that was really serious about joining the euro and which wanted to go in at a more competitive exchange rate would be preparing the way by tightening fiscal policy to allow the Bank of England to lower interest rates, whereas the opposite is the case.

Yet for all evidence to the contrary, the prime minister is more determined than ever that next year he will fight and win a euro referendum. His critics say that he sees this as his one chance of doing something historic. Maybe so. But he also believes that, so long as the Treasury's famous five economic tests can be met or fudged, euro entry is profoundly in the national interest. He sees an opportunity for Britain to lead the European Union—an opportunity that is unlikely to be repeated if it fails to join the euro soon.

The prime minister is more determined than ever that next year he will fight and win a euro referendum

Several things have made this possible. One is the erosion of the Franco-German axis that has been one of the consequences of Gerhard Schröder's chancellorship. Mr Schröder is not only less willing to defer to France than his predecessors for generational reasons, but also, as a German from the Protestant north, he feels more comfortable with the British than the French. While Tony Blair shed few tears for Lionel Jospin, he would be very sorry to see his friend Gerhard go the same way later this year: hence his appearance on German television this week alongside the chancellor to show solidarity in the struggle to marginalise Europe's far-right.

Secondly, while some European leaders have expressed puzzlement about, bordering on disapproval for, Mr Blair's shoulder-to-shoulder support for President Bush, it hasn't, in the words of one Downing Street insider, stopped them from angling for dinner invitations more assiduously than ever before. They may at times resent Britain's transatlantic exceptionalism and gung-ho militarism, but few would deny that, since September 11th, the prime minister's power and prestige within the European Union has grown.

Finally, Tony Blair and Gordon Brown are quite simply two of the “biggest” politicians in Europe. They are electorally successful on a scale that their counterparts can only dream about; despite the frailties of Britain's public services, they have a strong economy behind them; and they dominate meetings with other European leaders with a formidable combination of charisma, energy (Mr Blair), grip and forcefulness (Mr Brown).

Although all of this has happened without Britain being in the euro, Mr Blair believes it would be wrong to

believe that this will continue if there's no euro referendum. Both Number 10 and British diplomats in Brussels argue that we are regarded as being “pre-in”—that is, there is widespread acceptance within the EU that it is Britain's intention to join the euro and that the intention will be acted upon in the course of this parliament.

In March, a leaked memo from the head of Britain's permanent representation in Brussels, Sir Nigel Sheinwald, pointed out that Britain had been excluded from the important meeting that decided to spare Germany and Portugal the indignity of being formally warned about the size of their budget deficits. Sir Nigel suggested that this was a watershed and that important economic decisions would in future increasingly be taken by the 12-nation “eurogroup” rather than by Ecofin, the forum at which all EU finance ministers are present.

For the time being, Sir Nigel's fears have not been realised: Ecofin remains the senior economic decision-making group and, when it meets, Mr Brown is still, according to his officials, very much a first among equals. But the longer a referendum is delayed, it is argued, the weaker the British position becomes.

The same reasoning is deployed when it comes to direct investment from overseas—nothing bad has happened yet because industrialists, such as Nissan's Carlos Ghosn, have been convinced by the prime minister's assurances that Britain will be in the euro before long. If Mr Blair were to say next year that the time was not ripe, the conclusion they would draw is that it probably never will be.

According to people close to Mr Blair, the chances of a referendum next year are considerably higher than 50-50. Of course, they have an interest in conveying a sense of inevitability both to soften up opinion and, with any luck, to massage the pound down. However, the impression they give is that the prime minister will not be easily deflected from the course he favours.

The duopoly rules

But doesn't Mr Brown have a veto? Of course he does. An opinion poll conducted by Labour's pollster, Philip Gould, that wound up this week in the hands of the fervently anti-euro *Daily Telegraph*, indicated two things: first, more than 40% are now in favour of the euro; second, two-thirds would think that joining would make economic sense if Mr Brown were to declare that his five tests had been well and truly met. The poll didn't inquire what might be the impact on opinion of Mr Brown going off in a huff. It didn't have to.

Mr Brown is not anti-euro, as is often suggested. Although he thinks his own arrangements for conducting monetary policy take some beating, he is willing to recognise that over the long term euro membership could bring benefits. Nor does personal rivalry with Mr Blair inform his position to anything like the extent that gossip insists.

Mr Brown is not anti-euro, as is often suggested

Mr Brown is genuinely worried about the short-to-medium-term economic risks, and especially about the consequences of Britain joining the currency union with the pound around its current exchange rate with the euro, and the euro subsequently appreciating against the dollar. The economy would adjust, eventually; but adjustment could be prolonged and painful, and the resulting lower-than-expected growth would frustrate the government's plans to improve the NHS and other public services.

It's tempting to talk in terms of one or other's views prevailing: on one side a determined and strong-willed prime minister convinced of where the national interest lies; on the other, a cautious, but unusually powerful chancellor doggedly resistant to jeopardising the economic underpinnings of the government's social programme. That makes better newspaper copy than the reality, which is that at some point this year or early in 2003, Mr Blair and Mr Brown will sit down and reach a decision together. That is how this most duopolistic of governments works.

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Scottish football

New threat from the Old Firm

May 16th 2002
From The Economist print edition

Celtic and Rangers, Glasgow's old footballing enemies, are threatening to join the English league. Oddly, this might be good for Scottish football

PA

Celtic and Rangers at play

REAL MADRID'S victory over Bayer Leverkusen at Hampden Park, Glasgow, on May 15th did not make much impact at the Bar 67, a pub a few miles away which commemorates the only time a Scottish team, Celtic, won the European title. There was general agreement among the clientele that the game was less important than the flurry of meetings taking place around it. Football bureaucrats have had a shock: Celtic and Rangers, Scotland's two biggest clubs, want to quit Scottish football and play in the English league.

Scottish football is in a mess. Apart from Celtic and Rangers wanting out, the Scottish Premier League's other ten clubs say they will quit the league in two years' time and form another. Wrangling between the ten and the two means that, so far, there is no TV money for anybody next season. One of the ten, Motherwell, has declared itself insolvent as a result. In the lower divisions, Airdrie, a 124-year-old club, has gone bust. And the national team has failed to qualify for the World Cup finals for the second time since 1970.

The problem is that Rangers and Celtic, known as the Old Firm, dwarf the other Scottish clubs. They (usually) win all the trophies, their combined turnover in 2001 was £90m ($130m), nearly twice the combined £48m turnover of the ten, and their supporters outnumber all the rest as well.

Like any business which has outgrown its market, they want a bigger one. The English Premiership is their preferred solution. Their turnover would put both of them among the top ten English clubs. As the Premiership has said no, they want to join the English Nationwide first division and get promoted into the Premiership. This would answer the Nationwide clubs' prayers as they, thanks to the collapse of ITV Digital, are £178m short this season. Bringing in the Old Firm might well attract some TV money. But if the two biggest Scottish clubs quit Scotland, wouldn't that deal a mortal blow to the game north of the border?

Probably not. Much of Scottish football's problem is that, barring a fluke, no club outside the Old Firm will win the league. Luring spectators is therefore hard. John Boyle, Motherwell's chairman, spent £11m trying every marketing ploy he could, and failed. The Bar 67's pundits point out that, without Rangers and Celtic, the other clubs could win the Scottish league and qualify for European football.

The other oddity of the Scottish game, says Richard Giulianotti, a sociology lecturer at Aberdeen University, is that Rangers and Celtic and their supporters have become divorced from the rest of Scottish football. Scottish Saltire flags are absent from either club's ground; Irish tricolours predominate at Celtic Park, Union Jacks and even the cross of St George are evident at Rangers' Ibrox stadium. Mr Giulianotti says that Rangers have fuelled antipathy in the rest of Scotland by seeming reluctant in recent years to let their few Scottish stars turn out for the national team.

But if they were playing English sides, their Scottishness might reassert itself. Games would not just be about inter-club rivalry, but inter-country rivalry. John McKenna, in the Bar 67, reckons that it might even reduce the ferocity of the Catholic-Protestant sectarian divide between Celtic and Rangers. “Better that the other fans call us Scottish bastards rather than Fenian or Orange bastards,” he says.

UEFA, which runs European football, fears that if the Scottish teams switch, other big clubs in small countries like Belgium and Denmark might move to the French or German leagues, so weakening its control of the game. But that looks suspiciously like a restraint on free trade, which EU rules forbid. The Hampden final could be remembered as the start of a revolution in European football rather than for a spectacular winning goal.

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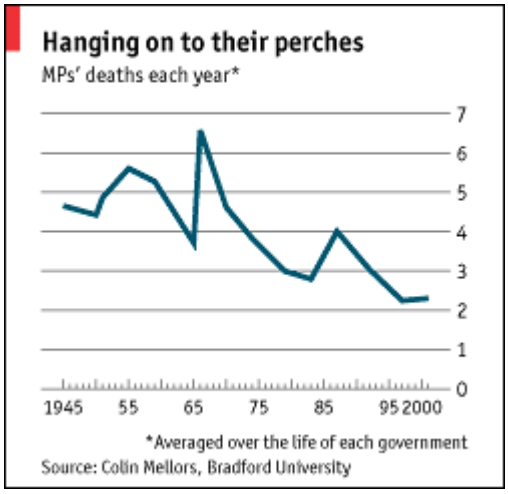
Death and politics

The disappearing by-election

May 16th 2002
From The Economist print edition

No drink, no fags and no more roly-poly pudding puts years on an MP's life



BY-ELECTIONS used to offer a regular measure of the government's popularity. But in the past five years, there have been only 18, barely a third of the post-war average. One explanation is that prime ministers are increasingly reluctant to risk an electoral slap in the face by elevating backbenchers to the House of Lords in mid-term. But the main reason is that MPs are living longer.

Why is a bit of a mystery. MPs, unlike policemen, are not getting any younger. Their average age today is 50—the same as it has been for half a century. Admittedly, life expectancy for the population as a whole has increased. The mortality rate for 50-year-olds fell from 7.25 per 1,000 in 1960 to 4.1 in 1999. But MPs are doing even better than that. In the last parliament, there were only 9 deaths (2.25 per year), compared with 27 deaths (6.75 per year) in the 1966-70 parliament.

So what is the secret of MPs' increased longevity? The Sergeant-at-Arms, who controls most aspects of parliamentary life, is reluctant to speculate. But Colin Mellors of the University of Bradford notes that, though MPs on average may be no younger, fewer are of pensionable age. In 1950, there were 118 MPs aged 60 or more compared with only 77 last year. This is probably because parties are giving their older MPs a discreet push before elections.

MPs have changed, too. Gone are the horny-handed sons of toil straight from the mines and the factory floor. The polytechnic lecturers, political researchers and *garagistes* who have replaced them tend to have led less physically demanding lives.

The arrival of the “Blair Babes”—101 Labour women MPs—in 1997 may have had an impact, too, because women's life expectancy is greater than men's. And they may have helped change the culture, as well as the statistics.

Once the House of Commons was famed for its crowded bars and heavy drinking. No longer. Annie's Bar used to be packed with sozzled lobby correspondents and toping MPs. Now the barmaid complains that business is terrible. “Some days, there are only three or four people here all day,” she says.

MPs spend more and more time toning their pecs in the Commons gym, which reports brisk business. More than 100 a year take advantage of a free parliamentary medical check-up. Roly-poly pudding and custard no longer figure on the Commons menu. Instead there are “healthy eating” options. The “smoking room”, to which MPs used to retire for a post-prandial brandy, is a pale shadow of its former convivial self. *O tempora, o mores*.

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Academic pay

Its own reward

May 16th 2002
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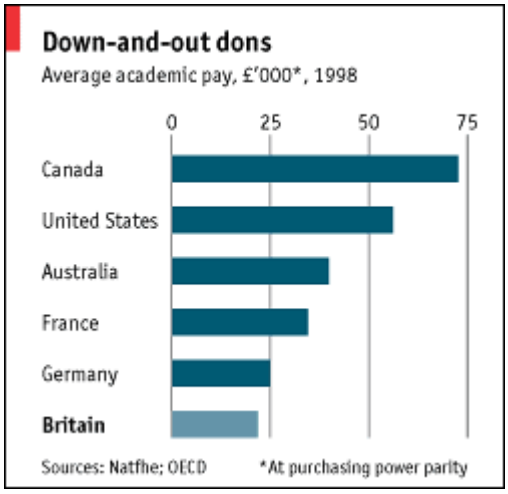
The government wants more university students. Who is going to teach them?



"CUTS, cuts, cuts," complains Morris Zapp, a flashy visiting American professor in David Lodge's novel "Nice Work": "that's all anyone will talk about here." As Mr Zapp says, the moan of penurious British academics is familiar. But their lowly pay is threatening to become a problem for the government, as well as for the boffins and their bored interlocutors.

On the face of it, the plight of academics ought not to command much sympathy. They enjoy long holidays, and spend a lot of time thinking about their favourite recondite subject, subsidised (if stingily) by the taxpayer. The most glamorous or marketable of them can boost their earnings with consultancy or media work.

These attractions have helped to compensate for the poor pay. But in the last few years, earnings growth in other public-sector occupations, as well as in the private sector, has outstripped that in the remuneration of dons. A new lecturer at one of the old universities now earns about the same as a new policeman, despite his many years of extra training (not to mention the concomitant debt). Compared with most other professions, his pay will rise slowly and undramatically.

The government has come up with the occasional dollop of cash to ease the pain. But according to research published last week, the penny is dropping among potential academics. The number of British universities regularly struggling to recruit them trebled between 1998 and 2001; almost 60% reported difficulty in recruiting lecturers. Predictably, the problem is gravest in subjects such as engineering, economics and law, whose potential recruits are attractive to private businesses, though schools and hospitals have also become financially alluring. An impending retirement bulge won't help.

One of the problems with academic pay has traditionally been the inflexibility of national pay scales. Wealthy universities are finding ways around them, but even good British salaries lag behind those in comparable countries. Many of the best and brightest are joining Mr Zapp in America: five times as many Royal Society fellows are based there as in 1960. At the other end of the food chain, a study by the British Academy (which dishes out research funds for the arts, humanities and social sciences) suggests that the anticipation of a lifetime of penury is inhibiting good students from doing doctorates.

However cosseted academics may be, if the government wants Britain to have world-class universities, it ought to be worried about declining quality—and about sheer quantity. During the expansion of higher education in the last 20 years, the ratio of students to teachers doubled. The government now wants 50% of under 30s to experience higher education by 2010. Doubts have been raised about where it will find all those students (in particular, how many will come from low-income families). But universities will also have to conjure up around 17,000 lecturers to sustain the current staffing ratio.

Last week's report was—unusually for a pay plea—commissioned by university employers rather than the unions. The universities are hoping to secure a generous settlement under the forthcoming comprehensive spending review. After the CSR, the government is due finally to reveal its (revised) blueprint for student finance. When deciding how to allocate the extra cash it splashes on higher education, ministers may, unfortunately for academics, bear in mind that students and their parents have more votes than they do.

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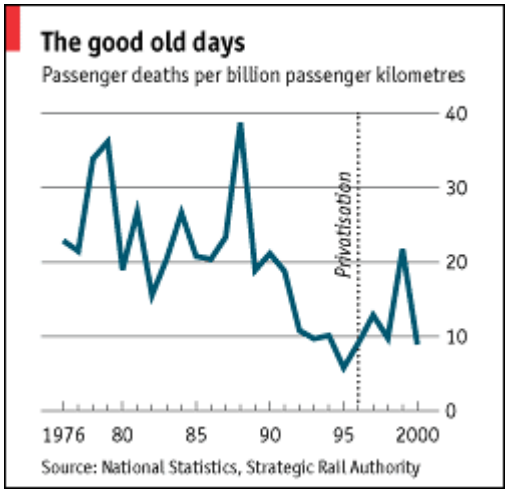
Rail safety

The usual suspect

May 16th 2002
From The Economist print edition

Can privatisation be blamed for rail deaths? Probably

PA



WHEN a disaster happens, it is natural to look for someone or something to blame. Thus it has been since seven people were killed after a train crashed into Potters Bar station in Hertfordshire, on May 10th. It was the fifth big rail accident in as many years; after a derailment at Hatfield, not far from Potters Bar, in October 2000, extensive speed restrictions and repairs paralysed the rail network. Now, as then, many observers have blamed a convenient and unpopular villain: privatisation.

Privatisation does not necessarily mean less safety. Japan, the world's safest railway, is partially-privatised. In principle (and, as experience in other industries suggests, in practice too) a privatised railway, with a proper regulatory framework, ought to be safer than a public one. It is simply not in the interests of private companies for customers to die while under their care.

But rail safety in Britain, which improved sharply during the 1990s (see chart) has slipped back since privatisation to the level seen during much of the 1980s. The death rate remains a lot lower than in the 1970s, but errors at the time of privatisation did help it to deteriorate.

Britain's railways were starved of investment in the run-up to privatisation in 1996. That is why so much of the track is in such a bad state. Cracked rails caused the crash at Hatfield that killed four people. The division of the railways between track and operators can be blamed for other problems. The Cullen Report into the crash at Ladbroke Grove that killed 31 people in 1999 pointed out that drivers had not been warned about the problems with the faulty signal that led to the crash. At Potters Bar, loose bolts were to blame. Nobody yet knows why that happened, but fingers are being pointed at the relationship between Railtrack and private contractors responsible for maintenance.

If the structure of the industry is the problem, what's the solution? The government has supposedly been working on one since it put Railtrack into administration last year. There is no sign of one yet.

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Airports

Money talks

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The runways of new airports are to be paved with gold

EVER since the row over the building of Stansted to the east of London in the 1960s, ministers have tended to take the view that decisions on new airports were best left to their successors. That is no longer an option.

PA

Coming to an airport near you

London's main airport, Heathrow, is already acutely congested. The five airports serving the capital handle more than 100m passengers a year. By 2015, demand for travel in the south-east is expected to reach 160m passengers, far above the airports' current capacity limits, and over the next 30 years, passenger numbers are expected to treble.

The minister for transport, John Spellar, has said that unless more runways are built in the south-east, airline passengers will have to pay £100 extra for each ticket and the economy will lose £20 billion. This is more than just political posturing. A study by Oxford Economic Forecasting in 1999 found that the aviation industry contributes some £10 billion to the economy annually and supports, directly and indirectly, more than 700,000 jobs around the country.

The government has no intention of letting hostility to airports constrain the industry's growth. A White Paper, to be published early next year, is likely to recommend not just the rapid expansion of Stansted but also other new runways in the south-east. There is even talk of a big new 24-hour airport somewhere on the Thames estuary. Consultation papers, to be published in the next few weeks, will set out the options.

There will, of course, be trouble. Nobody wants their sleep disturbed and the value of their house slashed by a nearby airport. But ministers think they have found a way of alleviating the pain and muffling the cries of protest: cash.

At present, airport operators have to compensate home owners if the price of their property falls because noise levels increase. But the legislation is so restrictive that few people are entitled to claim and the amounts received are paltry. Noise insulation grants have in the past been given to those living close to Heathrow and Gatwick; but, again, the numbers involved are tiny and the grants often meet less than half of the cost of the insulation.

Across the Channel, money is used to lubricate the planning system. While Britons whose houses are compulsorily purchased by the government get market value, the French get another 25% on top of that. The rapid expansion of Charles de Gaulle airport at Roissy, 14 miles (23 km) to the north-east of Paris,

was also eased through the help of large grants for community facilities and improved transport links. It is hardly surprising that the French view the building of large infrastructure developments with more enthusiasm than do the Brits.

Ministers are similarly planning to make airports, airlines and, indirectly, their passengers pay for a wide range of local facilities from sports centres to high-speed rail links in those areas selected to have new runways. The aviation industry has got the message. Mike Hodgkinson, chief executive of Britain's leading airport operator, BAA, visited Charles de Gaulle last month together with other leading airline executives to find out just how much it cost the French aviation industry to expand the airport. British taxpayers will no doubt soon find out.

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Interest rates

The only way is up

May 16th 2002
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The Bank is more optimistic about growth so interest rates are bound to rise

IN APRIL, Gordon Brown announced big spending and tax increases in the years ahead. A month later, the Bank of England has assessed what the chancellor's measures mean for monetary policy. In its quarterly *Inflation Report*, the Bank's Monetary Policy Committee (MPC) says that the budget's net effect will be to boost the growth of demand in 2003, which in turn will contribute to inflationary pressures. If the Bank's base rate were to remain at its 38-year low of 4%, inflation would rise above the government's target of 2.5% in early 2004. This means interest rates are going up later this year: the only question is when and by how much.

The way that Gordon Brown has chosen to finance his spending increases is also likely to add to inflationary pressures next year, according to the MPC. From next April, employers will have to pay an extra £4 billion a year in payroll taxes. In the long term, the committee thinks that firms will be able to pass this cost increase on to their employees, by curbing pay increases. But in the short term, it expects that they will meet some of their higher tax bill by raising prices.

Gordon Brown's budget is not the only reason why the MPC has pushed up its projections for economic growth next year. The house market is booming and consumers are borrowing merrily. As a result, the committee now expects less of a slowdown in consumer-spending growth than it did three months ago. Consumer expenditure will show “rather greater resilience than previously judged”.

Putting it all together, the MPC now predicts more rapid growth in GDP in 2003 than it did in the February *Inflation Report*. Then, it thought there was only a one-in-three chance that the economy would be growing by more than 3% in the year to the fourth quarter of 2003; now it thinks that the probability is more than a half.

The MPC estimates that the potential rate of economic growth is a bit higher than 2.5% a year. So sustained growth of 3% will start to push up inflation in the second half of 2003 as production outstrips capacity. By early 2004, inflation will rise to 2.6%, according to the committee's central projection, if interest rates stay at 4%.

It takes about two years for interest-rate changes to have their full effect on inflation. So why did a forward-looking MPC not raise rates when it met earlier this month? The main reason is that it wants to see solid evidence that the economy is making a durable recovery before it tightens monetary policy.

The economy stalled in the final quarter of 2001 and the first quarter of this year. Presenting the *Inflation Report*, Mervyn King, deputy governor of the Bank, said that “it looks increasingly clear that the trough of the recent slowdown was towards the end of last year”. Business surveys have been pointing to a sharp recovery, but so far this has not materialised in official measures of output. In March, for example, manufacturing production dived again. In a further indication of continuing economic weakness, the number of people claiming unemployment benefit rose in March and April.

Another consequence of the slowdown is that it has opened up more spare capacity in the economy. This gives the Bank more leeway before it has to raise interest rates. Even so, the *Inflation Report* sends a clear message that monetary policy will be tightened in the second half of this year. That leaves room for

City economists to disagree over when exactly this will happen. Ciaran Barr at Deutsche Bank thinks that the Bank is most likely to start raising rates in August; he expects rates at 5% by the end of the year. Danny Gabay at J.P. Morgan Chase thinks that rates could rise even earlier but will only reach 4.75% by the end of the year. On the other hand, Ben Broadbent of Goldman Sachs thinks that rates will not rise until the final quarter of this year, when they will increase by only a quarter of a point.

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Bagehot

Tony's boob

May 16th 2002
From The Economist print edition

The prime minister can't see anything wrong with taking money from a pornographer. He should think again

"IT'S another Groundhog Day," groaned Godric Smith, the likeable civil servant whose job it is to give most of the morning briefings to the parliamentary media lobby. Mr Smith was having a bad time fielding questions about the latest "cash for favours" revelation: only days before being cleared by regulators to buy the ailing Express Newspapers group, Richard Desmond, a pornographer, had given Labour a cheque for £100,000 ($145,000) to spend on advertising in his new acquisition.

From Bernie Ecclestone to Lakshmi Mittal via the Hindujas, Enron and, most recently, PowderJect, Labour's unfussy approach to getting itself funded keeps on landing the government in hot water. Of late, Mr Smith's technique for dealing with the lobby's awful doggedness has been to affect boredom: do we really want to go round these houses yet again? One can see his point. The evidence for any connection between an individual donation and a particular action undertaken by government has never been more than tenuously circumstantial. Ministers are not, in the accepted sense of the word, corrupt.

In this case, although there was the added frisson that the minister responsible for nodding through Mr Desmond's deal early last year was none other than Stephen Byers, who moved from trade and industry to transport only to see his career wrecked by the railways, that aspect of the story went cold quite quickly. There were no competition grounds for turning Mr Desmond down, only the possibility that it was not in the public interest for such a person to own decent newspapers, a clause in the takeover rules that had once been used (controversially) to stop another pornographer, David Sullivan, from winning control of the *Bristol Evening Post* group. Given that the *Express* papers, unlike those in Bristol, operate in a fiercely competitive market, even Mr Byers had enough nous not to step in.

If it wasn't influence, exactly what did Mr Desmond, previously a Conservative donor, think he was buying? Some of Mr Desmond's magazines, such as *Big & Black*, *50 & Over*, *Working Girls* and *The Very Best of Mega Boobs*, possibly hint at a Labourite passion for fighting social exclusion. It is more likely, however, that the money was a gesture of appreciation of Mr Blair's success, putting the prime minister in the same category as David Beckham, the England football captain, and the other celebrities who are paid to "share" their lives with the readers of *OK!* magazine (another of Mr Desmond's publications).

What has kept the story going is a growing sense of unease, not only that the prime minister was prepared to take Mr Desmond's money, but that he appears to have no idea why many natural Labour sympathisers are disgusted by it. Mr Blair stated his attitude quite clearly in a television interview on May 16th: Mr Desmond was the owner of Express Newspapers and, as such, accepting a donation from him was perfectly fine. That Mr Desmond is the proprietor of the *Daily Express* makes him, in Mr Blair's eyes, instantly respectable. That he continues to make considerable profits from magazines, a television channel and a website that would shock many people appears to worry the prime minister not one jot.

So, what's not to like?

In some ways, Mr Blair's lack of concern shows an admirable determination not to succumb to the political correctness that afflicts many on the left. It's also another manifestation of Mr Blair's "big tent" politics that there's a welcome even for the likes of Mr Desmond. After all, Mr Desmond's operations satisfy a demand and are (as far as we know) perfectly legal and pay taxes. His business may in some sense be "exploitative", but it is hardly uniquely so: he doesn't own third world sweatshops or destroy the environment. Besides, surely what Mr Desmond peddles is harmless, rather jokey, soft porn. And anyway, isn't porn these days quite cool in a post-modern sort of way? Finally, since buying the *Express*

titles, Mr Desmond has been trying to sell his porn empire—“time to move on,” he said.

It doesn't quite wash. These days, the line between soft and hardcore porn is pretty blurred. If Mr Blair thinks that people are being too censorious about his new chum, a few minutes spent on Mr Desmond's main website might change his mind. When Mr Desmond became the owner of Express Newspapers, many hard-bitten journalists were sufficiently horrified to jump ship at the first opportunity, some even leaving before they had other jobs to go to. As for “moving on” from porn, Mr Desmond seems in no rush. The price he's asking for his magazines—about £20m—has put off any possible purchasers. The main reason he wants to be shot of them is that their circulations are in long-term decline because of the Internet. Mr Desmond wants to keep his own Internet business as well as his lucrative television interests. The idea that he is little different from other publishers is comforting but untrue.

The prime minister's greatest fault in this matter is neither his naivety (if that is what it is) about the nature of Mr Desmond's activities nor even his unwillingness to make judgments about those who wish to associate with him. His mistake is simply that he has done a rotten deal. It was just about understandable that he should want to meet Mr Desmond in the hope that the *Express* titles would continue their (somewhat improbable) support for the government. The wooing of newspaper proprietors, however vile, is normal politics. But Mr Blair has accepted money that most Labour supporters will regard as tainted. In their eyes, he has been, however slightly, diminished. Politics and morality are inescapably intertwined and few politicians head for the moral high ground with greater alacrity than the prime minister. The next time he makes one of his great save-the-world speeches, many of his audience will suddenly find themselves thinking about Mr Desmond's magazines. It's a high price to pay for £100,000-worth of advertising in the *Express*.

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Capitalism and its troubles

May 16th 2002
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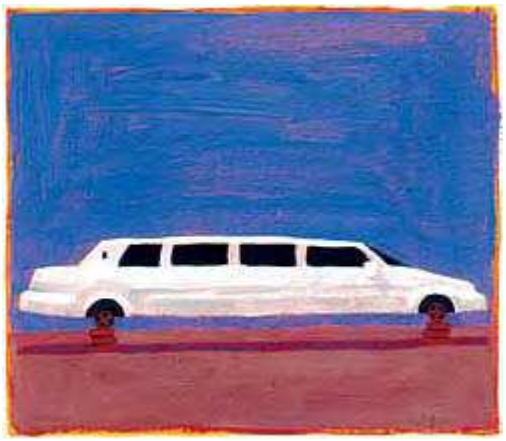
The capitalist system has proved surprisingly robust in the face of recent crises, but if it is to keep delivering the goods it needs an overhaul, says Matthew Bishop



CAPITALISM has had a rotten time lately. Not as rotten as in 1917, when those revolutionary shots in St Petersburg launched a form of anti-capitalism that ended (except in Cuba and North Korea) only just over a decade ago. Nor, with luck, as rotten as in 1929, when a stockmarket crash on Wall Street set off the global Great Depression. But rotten, nonetheless. Nobody knows for sure yet, but 2001 might come to be seen as the year when two decades of mostly unbroken progress for capitalism gave way to something more ambiguous and uncertain.

That year was the first in ages, perhaps since the start of America's great equity bull market in 1982, when the world became significantly less wealthy. Total global marketable wealth—that is, all assets traded in the financial markets, such as shares and bonds—fell by 4% last year, according to a study by the Boston Consulting Group. The number of households with at least $250,000 of marketable wealth dropped from 39m to 37m. Those who believed that in today's economy wealth always increases and the rich keep getting richer have been proved wrong.

The sudden collapse of Enron, a Texan energy-to-finance-to-fraud conglomerate, has shaken faith of another sort: in the integrity of corporate America, and in the Wall Street-centred model of capitalism that has been hawking its wares to investors the world over. The dotcom bubble was one thing; the realisation that apparently profitable companies are not making any money quite another. Much of the appeal of American securities to investors rested on the belief that companies have become much more productive and profitable. After Enron, investors are now questioning the accounts of many American firms, including such admired stalwarts as General Electric and American International Group (AIG), as well as some foreign ones. Given that the American economy has become the engine of the world economy and its companies are being held up as models, this is troubling.

If the doubts about the supposed revolution in productivity and profitability prove justified, the consequences could be dire. Huge amounts of debt have been accumulated by firms and individuals alike, in the belief that the general optimism about corporate America—reflected in continuing high share prices—is justified. Huge amounts of foreign capital have flooded into America for similar reasons, allowing the country to run an enormous current-account deficit and keeping the dollar strong. If these trends were reversed, America's economy could suffer serious damage, and America's model of capitalism might lose much of its appeal to other countries.

In many countries, experience calls that model into question in any case. Argentina's problems have already dealt a serious blow to the idea that the global triumph of capitalism is inevitable. Even such rich countries as Japan flinch from American efficiencies such as securitising bad debt and getting it off bank balance sheets. To a lesser degree Europe is also a reluctant capitalist. Progress of the model can no longer be taken for granted in large parts of Asia, Latin America and the former Soviet Union, and has never been a serious prospect in much of Africa and the Arab world.

The most awful shock of the past year was the terrorist attack on September 11th. The financial system stood up to it remarkably well. Moreover, both the American economy and, more broadly, the world economy have rebounded much more strongly than anybody dared hope. Yet the attacks proved that even where capitalism is well established, it is increasingly vulnerable to those who hate it. No amount of success in the current war on terrorism will eliminate this hideous new risk, which is impossible to quantify—as the insurance industry is indicating by making cover against it prohibitively expensive.

Assuming terror can be kept away from the developed world, there are two broad schools of thought about the future of capitalism. The bulls argue that the system's performance over the past year, particularly in America, bodes well for the future. Clearly, bursting stockmarket bubbles and scandal-ridden collapses of leading companies are cause for concern. But America has a long record of learning from its excesses to improve the working of its particular brand of capitalism, dating back to the imposition of antitrust controls on the robber barons in the late 1800s and the enhancement of investor protection after the 1929 crash. There is no reason why it should not turn the latest calamities to its advantage too. Senator Jon Corzine, a former boss of Goldman Sachs, puts the case for the optimists: “At the conclusion of any bull market there are always elements of excess that get washed out or cause the system to evolve. But the fact is, we are coming out of the most shallow recession in post-war history, and the outlook is good.”

Star performer

The resilience of the financial system has surprised even the regulators responsible for its health on both sides of the Atlantic. As one of them put it, “If you had told me on September 10th that we were going to get the terrorism, Enron and Argentina, I'd have predicted at least one major international financial institution going bust, and serious consequences for the economy.” As it is, the only financial firms to go under were on the fringes of the system: some banks in Argentina, and a handful of mostly long-troubled or small insurers.

The bears too have been surprised by the system's resilience, but they still see a large remaining financial bubble which they fear may burst, possibly plunging America and the world into a depression similar to that of the 1930s, or at least of the past decade in Japan. The threat of further terrorism, fighting in the Middle East (with its repercussions for the oil price) and maybe a transatlantic trade war, conjuring up ghastly parallels with the 1930s, have all clouded their crystal balls further. With Argentina's default, they feel, perhaps globalisation has peaked.

The dotcom bubble has burst, but not the bubble in the broader stockmarket. Pessimists predict economic collapse when it does. As Robert Shiller noted in his best-seller “Irrational Exuberance”, it can take a while for bubbles to burst, and longer for their full economic consequences to become clear. The Wall Street crash of 1929 was followed by numerous rallies and dips, and only a couple of years later by the Depression. For now, Alan Greenspan, the chairman of the Federal Reserve (and the man who coined the phrase “irrational exuberance”), continues to blow air into the bubble that his loose monetary policy has created. But he cannot pull off this trick forever. Interest rates can go only so low.

Neither the optimists' nor the pessimists' scenario is inevitable. In America and elsewhere, there are important choices to be made that will influence the outcome. Should there be new rules to curb abuses by investment banks? Can accounting information be made more meaningful? Can the incentives of company bosses be aligned more closely with the interests of shareholders? Can capitalism take root in the developing world? The answer to each of these questions is yes, up to a point, but what needs to be

done to achieve that result is not easy.

One big hurdle is that the will to reform may be lacking, especially if the world economy continues to recover. Already, there are signs that Congress is backing away from some of its more radical proposals (several of which will be no loss). As Harvard's Andrei Shleifer and others point out in a recent article, Wall Street's heart may not be in it either: “Compared to the profits directly related to high stock prices, those from unwinding bubbles must be minuscule.” Although market forces are likely to solve some of these problems, and are already punishing any firm that might conceivably become the next Enron, they may not be sufficient. Bill Gross of PIMCO, a huge bond fund, is unimpressed by the market's response: “My fear is that this newborn faux hostility in the investment attitudes of lenders and stockholders will go the way of many other short-term jiggles in the inevitable march of capitalistic excess.”

Is Mr Gross right? The answer lies in the financial system, which is where this survey begins.

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Crisis? What crisis?

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From The Economist print edition

The financial system has coped remarkably well with a horrendous couple of years

A HUGE, unexpected decline in profits. A sharp and equally unexpected rise in corporate bankruptcies. A sudden nationwide plunge in personal wealth. These are the classic early signs of a banking crisis, of the sort that has happened roughly every decade in America and has also become increasingly common in the rest of the world over the past quarter-century. Among the victims have been Britain, Scandinavia, France, Turkey, Thailand, South Korea, Mexico, Japan and Argentina.

Even without the tough economic environment, it would not have been surprising if the terrorist attacks of September 11th had caused system-wide banking failure, by disrupting the transmission of payments between banks and creating an atmosphere of fear. Yet in the event, banking and the broader financial system proved remarkably resilient. This is worth celebrating. Research into the banking crises of the past 25 years suggests that they typically cost around 25% of GDP to put right. How did things, so far, turn out so much better this time?

Clearly, after the horrors of September 11th, fortune smiled in adversity. The war on terror proceeded as planned, and there were no immediate follow-up attacks on American soil. Consumers remained confident and carried on spending, keeping both the economy and the financial system stronger than had seemed possible straight after the attacks.

It also turned out that the system was better prepared to survive the attack than might have been supposed. The elaborate precautions taken to deal with the supposedly devastating millennium computer bug, which until recently had been ridiculed as a waste of money, proved to have been an invaluable “stress test” for the financial system. They ensured that back-up systems and emergency procedures were in place when the disaster happened.

But luck was not the only reason why things turned out better than expected. Both the authorities and the market participants also showed remarkable skill in restoring the financial system after the attacks. Inevitably, there were unexpected heroes, including the usually despised local telephone company, Verizon, whose employees laboured impressively to reconnect downtown Manhattan. The interbank payments system slowed for a while after the attacks that Tuesday morning, but did not break. The bond market reopened on the Thursday. The New York Stock Exchange trading floor was back in action on the following Monday.

Textbook response

The Fed and other central banks played their parts to perfection. In effect, they allowed unlimited

lending, and suspended normal prudential requirements for banks to set aside capital against loans. Banks increased their lending to provide short-term finance for companies suddenly deprived of access to the commercial-paper market. If ever there was a time to flood the system with liquidity and deal with the consequences later, this was it, especially given the technical difficulties faced by some banks (notably the Bank of New York) in clearing payments.

Had the market started to fear that some payments would not be cleared, the resulting panic could easily have taken down one or more big global banks and many of their clients as well. The Fed, and some foreign regulators, took on enormous credit risk. But so long as the liquidity was withdrawn (which it was as soon as the need had passed), for once there was no concern about creating a moral hazard. Banks would hardly leave themselves recklessly exposed to the after-effects of a terrorist attack simply because they expected the Fed to come to the rescue.

For a crucial moment, regulators everywhere turned a blind eye to rules—for example, on solvency for insurers—that would have caused chaos if rigidly enforced. New York and London proved more interchangeable than expected. Many firms were able to shift their operations to London immediately, flying lots of staff over from America. Britain's Financial Services Authority helped by giving instant authorisation to the workers when they arrived. Most of the banks, brokers, stock exchanges and other firms that operate the financial system also suspended their usual practice of competing at every opportunity, pulling together in the interest of the system as a whole. This has not always happened in past financial crises.

Not quite everything went smoothly. The Bank of New York discovered it had been unwise to keep its main back-up facility only two blocks from its head office. Other firms have taken note. In New York, back-up facilities are now being placed in New Jersey or even farther afield. In London, banks based in the City are opening back-ups in Canary Wharf a few miles away, and vice versa.

Is that far enough apart? “If something takes out both the City and Canary Wharf at once, there will probably be more to worry about than the health of the financial system,” says one regulator. Another explains that thanks to the steps taken after September 11th, the financial system is now “inoculated against every terrorist act, short of nuclear or other weapons of mass destruction”. That will have to do.

Bigger, broader, stronger

In America and the richer European countries, in particular, the financial system has undergone huge changes over the past decade. Some of them help to explain why the recent calamities did not do more damage. But not all of them are for the better, and some raise new dangers.

For the most part, the industry leaders today are no longer banks, but financial-services companies. Their activities extend far beyond traditional commercial-banking tasks such as taking in savings and making loans. Many now engage in investment-banking activities such as underwriting bond and equity issues, advising on mergers and acquisitions and, crucially, selling on loans to other investors (by organising syndicates, buying credit derivatives that pay out in the event of a default or issuing securities bundling loans together).

Enron's use of such techniques may have given them a bad name, but many banks seem to have used them to reduce their exposure to credit risk—the traditional way they lost money—so they could remain active in the more profitable business of arranging credit for clients. Asset management, for both institutions and individuals, also accounts for a growing share of revenues, and is expected to become much more significant over the next five years. So, too, is the sale of insurance products.

A decade ago, continental European banks were typically engaged in a broader range of activities than their American counterparts, which under the Glass-Steagall act, now scrapped, had to make a choice between commercial banking, investment banking or insurance. But the big multinational financial-services firms today have gone much further than the European firms of ten years ago. They are certainly much bigger than any previous financial businesses, as measured by the latest market capitalisation of the top 15 firms compared with the 1990 figure (see table 1).

A bigger balance sheet makes it easier to absorb the sorts of

losses that J.P. Morgan Chase suffered when Enron went bust. There are hardly any triple-A rated banks left, but with the exception of Japanese banks—many of which might face bankruptcy without the implicit support of the government—the world's big financial firms are mostly well-capitalised. This is thanks in part to regulatory pressure, notably through the Basel capital-adequacy standards, and in part to growing market sensitivity to the financial soundness of lenders. Today, the big financial firms mostly have more capital relative to liabilities than regulators require, though recent losses may have reduced the cushion.

Growth has been achieved both organically and through a wave of mergers and acquisitions. M&A has been particularly important in helping the big financial firms to become genuinely international in their operations. In America, where until the 1980s many banks faced severe prohibitions on expanding across state lines, M&A has also helped reduce the exposure of individual firms to any one local economy. In the 1980s, a failure like Enron's would probably have taken down the Texas banking system. But Texas Commerce Bank, one of the company's long-standing bankers, was long ago absorbed into J.P. Morgan, which is able to cope with bigger-than-expected losses from Enron without any serious threat to its viability. Argentina's main banks are part of institutions based in Madrid, Boston and New York, which probably gave the country more time to deal with its problems than it would otherwise have had. Unfortunately, it did not use the breathing space to best advantage.

Overall, today's bigger financial institutions are finding it easier to heed the old advice about not putting all their eggs into one basket. Their exposure to credit risk is now geographically diversified and balanced by exposure to risks in other lines of business which, they hope, are not closely correlated with the credit cycle. More of the credit risk has been shifted to other investors who, at least in theory, are able to suffer losses without the troublesome consequences for credit creation, and thus economic growth, that big losses in the banking system have often caused in the past. The emergence of thriving public-debt markets has anyway reduced the economy's dependence on bank credit.

What a difference a decade makes 1

Top financial firms, market capitalisation, end year
$bn

	1990	
1	Industrial Bank of Japan	57.1
2	Fuji Bank	52.0
3	Mitsui Taiyo Kobe Bank	46.3
4	Sumitomo Bank	46.0
5	Dai-Ichi Kangyo Bank	44.8
6	Mitsubishi Bank	44.0
7	Sanwa Bank	41.2
8	Nomura Securities	25.5
9	Long-Term Credit Bank	24.8
10	Allianz	24.6
11	Tokai Bank	21.3
12	Mitsubishi Trust & Banking	17.2
13	Deutsche Bank	16.4
14	American International Group	16.3
15	Bank of Tokyo	15.9

	2001	
1	Citigroup	259.7
2	American International Group	207.4
3	HSBC Holdings	109.7
4	Berkshire Hathaway	100.2
5	Bank of America	99.0
6	Fannie Mae	79.5
7	Wells Fargo	73.7
8	J.P. Morgan Chase	71.7
9	Royal Bank of Scotland	69.4
10	UBS	67.1
11	Allianz	62.9
12	Morgan Stanley Dean Witter	61.4
13	Lloyds TSB	60.3
14	Barclays	55.2
15	Credit Suisse	51.3

Source: Morgan Stanley Capital International

The recent bout of bubble-bursting and the huge sovereign and corporate failures of Argentina and Enron seem to have more in common with financial crises in the half-century before the first world war, when the damage from bank failures to other sectors was limited, than with the failures in the 1930s and recently in Japan, when the damage done to banks affected every aspect of the economy. Even so, there remains plenty to worry about.

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New dangers

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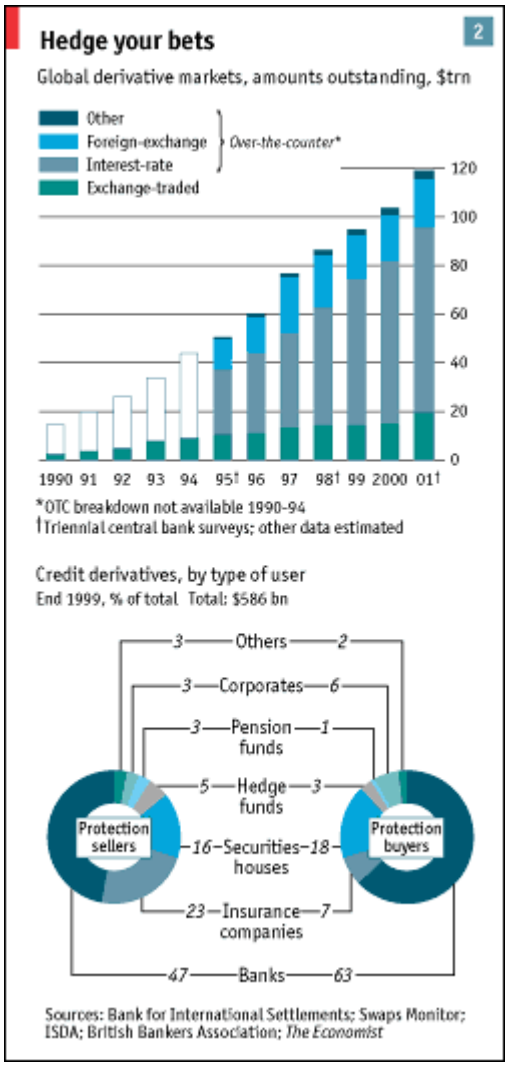
Relying less on banks and more on the markets creates fresh problems

BANKS are putting their eggs into more than one basket, and even selling some eggs to investors with baskets of their own. But are they as skilled at diversifying and transferring risk as they like to think? Are those to whom they are transferring the risk capable of managing it? Do these new holders even understand what risks they now bear? In short, could the shift from a bank-based system to a market-oriented one bring new dangers of its own?

Diversification does not absolve lenders from being prudent in their credit decisions. Banks have made some pretty dreadful loans in recent years. Obvious examples include the hundreds of billions of dollars lent to telecoms firms during the tech bubble, and generous credit extended to Enron and Argentina. From the mid-1990s, huge sums of money were promised to companies through guaranteed back-up credit lines to support issues of commercial paper, often without charge if no money changed hands at the time the credit lines were set up. When the economy turned down and credit became harder to find, many companies suddenly called on their back-up facility. By this time, lending billions of dollars to firms such as Xerox and Lucent had become an act of high-risk speculation that the banks had never contemplated, let alone priced, when the facility was first agreed.



One reason for this excessive generosity is that commercial banks were trying to win investment-banking mandates from companies, a business traditionally dominated by investment banks such as Morgan Stanley and Goldman Sachs. Underwriting an initial public offering or advising on mergers and acquisitions is much more profitable than lending money, so banks have been offering free loans to entice companies to give them investment-banking business. Judging by the chorus of complaints from the investment banks, this seemed to be working. However, the economics of the strategy are now looking less attractive in the light of the commercial-paper problems and a number of big losses on loans to large investment-banking clients.

The same forces that have pushed financial firms to grow bigger and more diversified are also raising the level of competition in the industry. In many product areas, a combination of fiercer competition, more transparency and the introduction of electronic systems is driving down margins. For example, margins on institutional brokerage are declining by around 5% a year. The collapse of IPO underwriting and the shrinkage of M&A in the past two years has taken out two of the few remaining lucrative areas of business, and helps to explain recent job cuts in investment banking.

Bob Gach, of Accenture, a consultancy, reckons that within a few years the industry could be dominated by only four to six global financial-services firms. Five years ago there were perhaps 20-25 banks with a chance of making it into this new “bulge bracket”. Now the number is less than a dozen. Each of the winners will probably need access to at least $100 billion of capital on its balance sheet. A few niche players will also survive. Dedicated investment banks such as Goldman Sachs will find it hard to decide whether to remain independent, says Mr Gach.

All this gives rise to various dangers. An ever-tighter squeeze on the profits of financial firms may tempt

them to take bigger risks in their proprietary trading operations, in the hope of staying independent long enough to make it into the bulge bracket. A surprising number of them invested heavily in venture capital during the tech boom, and after initially trumpeting stellar returns have now had to write off most of the money.

Derivatives allow their users both to shed risks and to take bigger risks. This dual role makes it hard to tell whether their impact is benign or malign, and there are plenty of people who argue for each side. What is certain is that financial firms, especially on Wall Street and in the City of London, love derivatives, and have hired an army of mathematicians and physicists to work as “financial engineers”, creating complex new derivatives to shift risk around the financial system. The market for these products is growing rapidly, both on futures and options exchanges and in private sales, which tend to be more complex and more lucrative. Credit derivatives already have a nominal value of almost $1 trillion, up from around $100 billion five years ago. They are forecast to top $3 trillion by 2005. The nominal value of over-the-counter derivatives now exceeds $100 trillion, 60% of which is handled by a mere five dealers, including J.P. Morgan and Citigroup. Derivatives and other tools of financial engineering can be used to manage risk better by hedging positions and transferring unwanted risk to a counterparty, which is what banks say they mostly use them for. However, those tools can also be used to increase risk, perhaps by a big margin, and there is a growing danger that this will be done accidentally.

Emanuel Derman of Goldman Sachs describes much of what a financial engineer does as “a high-tech version of estimating the unknown cost of fruit salad from the known price of fruit, or often, in reverse, estimating the unknown cost of fruit from the known price of fruit salad”. A financial engineer can take the risk in, say, a bond and break it down into a series of smaller risks, such as that inflation will reduce its real value or that the borrower will default. These smaller risks can then be priced and sold, using derivatives, so that the bondholder keeps only those risks he wishes to bear. But this is not a simple task, particularly when it involves assets with risk exposures far into the future and which are traded so rarely that there is no good market benchmark for setting the price. Enron, for instance, sold a lot of those sorts of derivatives, booking profits on them straight away even though there was a huge question-mark over their long-term profitability.

Black holes

The consolidation in the banking sector may be increasing the riskiness of the financial system in other ways. In a recent paper, Avinash Persaud of State Street, a bank, describes the growing frequency of what he calls “liquidity black holes”. Investors wishing to sell, particularly in large volumes, suddenly find that they can do so only at a much lower price than that set by brokers for small amounts, if at all. This is happening increasingly in some of the markets typically regarded as highly liquid, such as those for American Treasuries and foreign exchange, as well as in smaller markets such as for emerging-country debt. Volumes in the foreign-exchange market have fallen sharply (see chart 3).

The reason these black holes can develop, explains Mr Persaud, is that liquidity is a function not just of the size of a market but also of the diversity of opinion of those trading in it. The less they disagree, the less liquidity there will be. Several factors have reduced diversity, he argues. Technology has allowed information to spread faster, reducing the scope for disagreement arising from disparity of information. Consolidation has cut down the number of big market participants. In 1995, 20 banks in the United States accounted for 75% of forex transactions; by 2001, the number was down to 13.

Moreover, the big firms are increasingly using similar internal risk-management systems. These are sensitive to movements in the markets, and cause their users to respond in similar ways, so the few big firms that dominate the markets increasingly move as a herd, reducing diversity of opinion and thus liquidity, argues Mr Persaud. Some bank regulators say this danger is not all that significant because the underlying risks taken by financial institutions are quite different even if their risk-management systems are similar. But everybody agress that less liquid markets may be more prone to financial crisis.

Is there a way of increasing the diversity of opinions? One possibility would be for institutional investors

with different time horizons to become providers of liquidity. Big private investment-banking partnerships, such as Salomon and Goldman Sachs, used to be willing to take big contrarian bets in markets that they thought were out of line. But now that they are public companies, they are too concerned about short-term earnings volatility to take many such risks. Obvious candidates to take their place include hedge funds, which are free to invest against the grain of the market if they wish, and insurers and pension funds, which have very long-term liabilities and no need for market-sensitive risk-management systems.

Warren Buffett, a famously contrarian investor, often hints at this opportunity in the annual report of his firm, Berkshire Hathaway, which is, at root, an insurance company. The firm has plenty of liabilities that will not be called in for a long time, as well as diverse earnings, vast liquid resources and shareholders willing to accept the earnings volatility that can result from taking relatively risky positions. This “enables us to assume risks that far exceed the appetite even of our largest competitors”, as Mr Buffett puts it.

Where the buck stops

Some insurance companies are now starting to take on some of the risk that the banking system and traditional market intermediaries no longer want. Swiss Re and Munich Re each account for about 10% of the credit-derivatives markets. Insurers have also become huge buyers of asset-backed securities.

This may have its downside. Diversity of opinion is certainly welcome, but few contrarians, particularly within the insurance industry, are as sophisticated and well-informed as Mr Buffett. Indeed, many insurers have a reputation as the hicks of the financial world. Tim Freestone of Seabury Insurance Capital, a consulting firm, reckons that the investment and risk management of the typical insurer is roughly as sophisticated as the typical bank's was 10-15 years ago. Few insurers have a good record of underwriting, supposedly their bread and butter. During the 1990s many insurance companies simply parked premiums in the stockmarket, where they grew so much that there was no need to worry about underwriting losses. Now that the investment climate is harsher, the insurers are looking for new high-yielding (ie, riskier) investments, which banks are providing through financial engineering.

Fixed-income products, such as asset-backed securities, are particularly attractive to insurers with fixed nominal liabilities who failed to predict low inflation and low interest rates. Much of the Japanese life-insurance industry has gone bust because of its inability to deliver promised nominal yields. In Britain, Equitable Life got into trouble for similar reasons.

But some observers worry that problems lie ahead when the true risks of these investments become clear. In its December 2001 Financial Stability Review, the Bank of England devoted a whole chapter to risk transfer between the banking and insurance industry, mentioning “challenges for market participants and the authorities: in tracking the distribution of risks in the economy, managing associated counterparty exposures, and ensuring that regulatory, accounting and tax differences do not distort behaviour in undesirable ways”. Privately, one regulator admits that some insurers are “doing very racy investments to get yield”.

There is a danger that this risk will eventually find its way back into the banking system. Much of the risk-transfer apparently being undertaken may be an accounting ruse, designed to escape regulatory capital requirements without truly shedding the risk. And if insurers are unable to meet their liabilities and go bust, the banks may be caught short. There are potential legal risks too. J.P. Morgan, for example, faces a court battle to get the $1 billion it expected from a surety bond it had bought from a group of insurers to reduce its exposure to Enron.

Much of the risk may end up in the hands of less sophisticated investors, including some of the individuals now being targeted by the financial-services firms. They may be taking on this risk unwittingly. Nobody knows how those individuals might react if they found out, or how this would affect the economy as a whole. They might feel poorer and less inclined to spend, which could inflict the sort of damage on the economy and the banking system that the bears had predicted when the dotcom bubble burst.

If there is still a bubble in share prices, as many economists believe, the entire financial system—traditional and new bearers of risk alike—remains exposed to its bursting. But it has become harder than ever to say how great this exposure is.

Still, as long as risk remained concentrated within a country and largely its banks, its financial regulators

should have been able to keep tabs on it. The trouble with today's global pool of capital is that regulators may be out of their depth.

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Unexploded bombs

May 16th 2002
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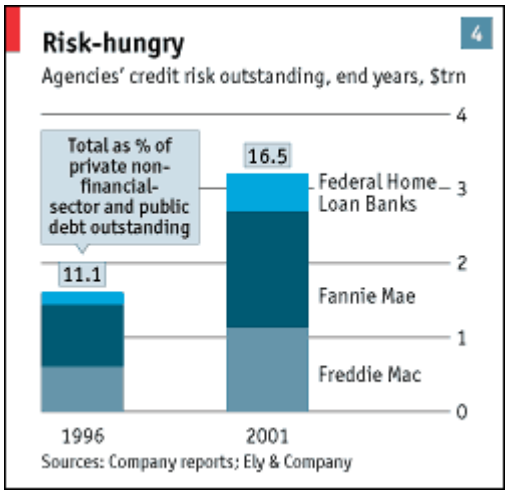
Beware of Fannie and Freddie



BANKS may be busy trying to get rid of risk, but two huge American institutions cannot get enough of it. The Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, known affectionately as Fannie Mae and Freddie Mac, have become arguably the two most worrying concentrations of risk in the global financial system. This is because of their portfolio of mortgages and securitisations, their use of derivatives and the habit of many other borrowers, including hedge funds, of using their debt as collateral.

At the end of 2001, Fannie had a total credit risk of $1.56 trillion (a $705 billion mortgage portfolio and guarantees on securitised mortgages of $859 billion). Freddie's was $1.14 trillion ($492 billion plus $646 billion), adding up to a combined exposure of $2.7 trillion, nearly double the 1996 figure of $1.45 trillion. Bert Ely, an economist, calculates that the current level amounts to a hefty 13.9% of the total credit risk in the non-financial sector of the American economy, and 49.8% of home-mortgage credit risk.

Worries about Fannie and Freddie owe more to concerns about corporate governance and sheer size than to any evidence of poor risk-management. The two were set up to ensure that the poor had access to affordable mortgages. They are “government-sponsored”, a vague status that allows them to maximise profits for their private-sector shareholders. It also earns them a subsidy from the markets worth an estimated $10 billion a year, because despite official insistence that there is no federal guarantee, Fannie and Freddie are so big, and so plugged into the Washington establishment (their boards are rest-homes for former government officials), that it is hard to imagine them being allowed to fail.

What might go wrong? They do not appear to be making the common error of using short-term finance to back long-term liabilities—though, as with any big derivatives user, it is hard to be sure. They stress-test their portfolios, for instance to see what would happen if the Texas real-estate crisis 15 years ago were repeated nationwide: say, a 25% fall in house prices, no home equity left, people defaulting on mortgages. They think they could survive that. The biggest danger may be counterparty risk: Fannie and Freddie are heavily dependent for their risk-management programmes on a handful of big banks. If there were an unexpected sharp rise in interest rates, those banks might be unwilling or unable to provide the derivatives Fannie and Freddie need to hedge their risks. The chance of this is small, but if it ever came to pass, the consequences would be huge.

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The regulator who isn't there

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Does a global financial system need a global regulator?

WHO regulates Citigroup, the world's largest and most diverse financial institution? With its operations in over 100 countries, selling just about every financial product that has ever been invented, probably every financial regulator in the world feels that Citi is, to some degree, his problem. America alone has the Federal Reserve, the Securities and Exchange Commission, the Commodities and Futures Trading Commission, the New York Stock Exchange, 50 state insurance commissioners and many others. Yet in a sense nobody truly regulates Citi: it is a global firm in a world of national and sometimes sectoral watchdogs. The same is true of AIG, General Electric Capital, UBS, Deutsche Bank and many more.

Might that be a good thing? Howard Davies, boss of Britain's Financial Services Authority, notes that it has become fashionable to think of regulators as Shakespeare's "caterpillars of the commonwealth, creatures who, far from adding value, get in the way of the market". Naturally Sir Howard does not share this opinion. All the same, it seems clear that much of the dynamism in global finance during the past three decades has been due to fewer regulations on the movement of capital, particularly across borders, and on what can be done with it. For the most part, money is now free to flow wherever an opportunity presents itself, and has generally done so, leaving everybody better off than with heavy regulation.

Leaving capital free to move where it could earn the highest return also showed up over-costly or misplaced regulation: the money simply went elsewhere. For instance, because Japan prohibited the use of derivatives, options in Japanese securities were traded in more accommodating Singapore. As Japan gradually eased these restrictions, some of the offshore business shifted back to Tokyo. In general, competition for capital has encouraged countries to improve their regulation to appeal to mobile capital—although some, such as Malaysia, have resisted this pressure, and continue to impose controls on cross-border capital flows.

Strikingly, there has been no race to the bottom in regulation. Behind every great market is good regulation—whether by a government agency or organised by the market participants. Internationally mobile capital has tended to reward regulation that protects investors and minimises privileges for market insiders.

Broadly speaking, this has led to a convergence of regulation around common international standards, but this process is by no means complete, particularly for investment products sold to personal investors. The day when a global firm can sell the same simple stockmarket-index fund anywhere in the world remains a long way off. America remains reluctant to allow European securities exchanges to ply their trade via screens in America, even though technically this is now easy to do. "Outrageously protectionist," comments one European regulator.

Given the political difficulties, the idea of a single global regulator is not on any serious agenda. That may be just as well: competition among regulators has some benefits. What is on the agenda, at least of the regulators in countries open to international capital, is to ensure that good information is available about the state of global markets and about financial firms' global operations. The FSA, for example, is able to regulate only Citigroup's British activities, but it will have a much better chance of doing it well if it knows enough about the health of the firm worldwide.

Information is already flowing more freely between different national regulators. Multinational institutions such as the International Monetary Fund, the Bank for International Settlements and the Financial

Stability Forum all play a useful part in this, but it is bilateral communication between national regulators that matters most—and the global financial system is nowhere near as transparent to national regulators as it should be.

One reason is that no global consensus exists on what exactly should be regulated. For instance, in Britain reinsurers are regulated by the FSA, but in their home markets Munich Re and Swiss Re, the world's largest reinsurance companies, are mostly unregulated.

Non-financial firms with big financial operations do not fit comfortably into the current regulatory framework anywhere. Enron, which has been plausibly described as an investment bank or hedge fund with an energy business on the side, was not regulated in America. In Britain, the firm itself was not regulated, but its financial subsidiaries were monitored by the FSA. There are big question marks over who regulates the growing number of firms now transforming themselves into financial behemoths, modelled on GE with its huge GE Capital operation. Hedge funds and other highly leveraged institutions are regulated lightly in most countries, and not at all in America. A proposal by a presidential working party for tougher regulation of hedge funds, prompted by the collapse of Long-Term Capital Management, was unexpectedly blocked in Congress.

Too much of a good thing

A second problem, at least in foreign eyes, is that America has too many different regulators. Whereas Britain has merged its numerous financial regulators into a single authority, and several other countries around the world are moving the same way, America continues with its plethora of different regulators for different parts of the financial-services industry. It seems doubtful that any of them has a good overview of what is happening in America's financial system as a whole—though the Fed claims it gets all the information it needs, one way or another. During the Clinton administration, regulation often took place on the golf course between Mr Greenspan, Arthur Levitt, the chairman of the SEC, and Robert Rubin, the Treasury secretary. All the same, single foreign regulators would find it easier to resolve cross-border issues with a single American counterpart.

Some American regulators defend their multiple system, despite the considerable duplication it entails, mainly on the ground that regulatory competition keeps them keen and lean. Certainly, the superiority of the single, consolidated regulator has yet to be proved. According to a report published last year by the Centre for the Study of Financial Innovation, “There is a pervasive mood of discontent in the City with the FSA: people find it bureaucratic, intrusive and insensitive.”

Still, the current division of labour among the different American regulators is hard to justify. Why, for instance, should the SEC oversee trading on stock exchanges and the CFTC trading on futures exchanges when the regulatory needs of all exchanges are essentially the same? And why is insurance regulated not federally but at the state level, mostly by elected insurance commissioners? Nobody really thinks this makes sense, but the system survives because each regulatory body has its own supporters in Congress. In some respects, an inefficient regulatory system suits powerful financial firms. The Glass-Steagall laws, which kept banks, investment banks and insurers separate, survived a dozen attempts in Congress to scrap them—until 1998, when Travelers, an insurer, merged with Citibank, which immediately ended its expensive lobbying against abolition. They went soon after.

One senator who thinks that a single regulator along FSA lines would be good for America's capital markets is Jon Corzine, a former boss of Goldman Sachs. “I hope to get consolidation of American regulation on to the agenda,” he says, “but it will need a bigger crisis than Enron to make it happen.”

So far America's cumbersome regulatory system does not seem to have retarded the development of its markets, but in the long run it may prove costly, particularly if—and it is a big if—the European Union succeeds in fully integrating its capital markets and introducing appropriate regulation. America has long boasted of having the most efficient capital markets in the world, and to date that has broadly been true. But its unwieldy system of multiple regulators could become a competitive disadvantage should Europe develop a better, less costly regulatory mousetrap.

Regulatory competition

Indeed, it is possible that pressure from the EU will help to consolidate American regulation. Under a

forthcoming EU directive, any financial conglomerate operating within the Union will have to choose a main EU regulator who will be responsible for global supervision of the firm. In practice, the European regulator for the big American firms, such as Goldman and Citi, will probably delegate by requiring the firm to nominate one of the American regulators as its “co-ordinating regulator”, which would become a de facto single national regulator for the firm.

Even if the infrastructure for effective global regulation were in place, huge challenges would remain. Some are of an intellectual sort. “How much failure should a regulatory system allow?”, asked Sir Howard Davies in a recent speech. He did not supply an answer, beyond saying it should be more than zero, and less than would cause system-wide collapse. Another regulator reckons that the ideal would be “a trickle of little problems, to keep people aware of the risks”. It may be a tribute to American regulation that Enron was actually allowed to go bust, and luckily this does not appear to have had system-wide consequences. Some countries might have tried to organise a rescue; indeed, even the Fed has a reputation for keeping alive firms that should have been allowed to die.

Understanding whether the level of risk is getting too high has become harder now that so much risk is being transferred out of the banking system. Andrew Crockett, general manager of the Bank for International Settlements, worries that regulators and financial firms alike are better at judging the relative riskiness of different instruments, institutions and counterparties than the total risk in the system.

The problem has been brought to the fore by the technology bubble, and the fear of a wider American equity bubble. Do regulators know when a bubble has formed and the financial system is becoming dangerously imbalanced? Probably not with enough certainty to base policy on. What is clearer is that aggregate risk ebbs and flows with the economic cycle, says Mr Crockett. Credit officers tend to lend too much in good times, heating up the economy, and then cut back too much in a downturn, making things worse. One way to get round this, Mr Crockett suggests, would be to require banks to set aside higher amounts of capital during economic booms than during recessions, to make risk-taking less pro-cyclical.

How much capital financial firms should set aside against risks going wrong is the trickiest decision international regulators have to make. Since 1988, big banks have been abiding by the Basel capital regime, which links the amount of capital they have to hold in reserve to the riskiness of the loans they make. However, the categories of risk are too undifferentiated: banks have to set aside as much capital against a loan to Microsoft as to a Hungarian dotcom, as much against a loan to America as one to South Korea. Banks have also discovered ways to use derivatives and other securities to allow relatively risky loans to qualify for a low-risk, low-capital treatment. Regulators fear that a large part of the growth in the use of derivatives and securitisation by banks may stem from evasion of regulatory controls.

Basel 2, a more sophisticated version of risk-based capital rules, is now in the pipeline. It is meant to apply not only to big banks but to all banks worldwide, and to all investment firms in the EU. There is also talk of an insurance Basel before long. But Basel 2 has met with considerable opposition, partly because it is too complicated, partly because some countries disagree over how much capital should be set aside against some sorts of loans. Germany wants a lower capital requirement for loans to small businesses, for example, because bank loans are their traditional source of funding. The launch of the new regime, originally scheduled for 2004, has already been delayed until 2006, and even that may prove to be optimistic. Meanwhile, the banks are operating with a capital regime that does not work as intended, but may be lulling regulators into a false sense of security.

In determining regulatory capital, Basel 2 would give an important role to credit-rating agencies such as Moody's and Standard & Poor's. How good their ratings are is the subject of much debate. As an alternative, banks will be encouraged to use their own in-house credit ratings. But regulators still mistrust the use of quantitative credit-risk models to set regulatory capital. They need better techniques and better data, especially in Europe.

Many big banks already use quantitative models to assess how much capital they need to set aside against portfolios of marketable securities. These “value at risk” (VAR) models typically measure the most the firm could lose in a day, judging by past performance, but they tend to underestimate the frequency with which really bad days occur. There have been half a dozen “perfect storms” in the market in the past decade, during which VAR calculations proved useless in predicting losses. Stress-testing portfolios against imaginary perfect storms remedies some of the weaknesses. But modelling credit risk in this way is much harder, not least because data about past credit performance are scarce.

Another market-based system of regulation has also received some attention. If banks issue short-term

subordinated debt that is traded every day and has to be refinanced regularly, and can stay in business only as long as the debt is refinanced, then the market will in effect regulate the bank. Lenders will not finance a bank they think is in risk of default. Alas, the only country to have tried it so far has been Argentina, where the government's fleecing of the banking system after its debt default rather spoilt the plot.

Regulators are only too aware that the sheer complexity of the financial system imposes practical limitations on what they can do. Increasingly, they are having to rely on the private sector to assist them in their regulatory task. They simply do not have the capacity to find out what risks are being taken inside a large international bank unless it tells them.

Caveat emptor

All this suggests that, just as market failures are an inescapable feature of free-market capitalism, so too may be regulatory failures by its watchdogs. The first line of regulation should be those whose money is at risk. In an important sense, Enron was regulated by its bankers. Alas, they made a lousy job of it. The best piece of advice to market entrants is “buyer beware”.

As it is, buyers often seem to be positively reckless, not least in the stockmarket. Recent years have seen the return of the sort of financial bubbles that many economists and regulators thought had gone forever. Why are bubbles back, and can anything be done to prevent them?

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Bubble trouble

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And what policymakers should do about it

MR GREENSPAN has allowed the creation of a potentially disastrous financial bubble, say Andrew Smithers and Stephen Wright, two British economists. In a recent article, they argue that the Fed's chairman, having chided the markets for their irrational exuberance in December 1996, should have raised interest rates by enough to bring the exuberance down to more rational levels, and share prices with it. Instead, he did nothing. Share prices continued to rise. People felt wealthier than they should have done, and spent more and saved less than was prudent. Companies with rising share prices borrowed more against their equity, which they invested in all sorts of risky activities, many of which proved unwise.

Messrs Smithers and Wright blame Mr Greenspan's do-nothing stance on two ideas. One is the “efficient-markets hypothesis”, one of the cornerstones of modern financial theory which is credited with revolutionising the workings of financial markets in the past quarter-century. In efficient markets, prices are assumed to reflect fundamental values and to incorporate all relevant information. When ill-informed investors move prices away from their true value, informed investors will arbitrage them back to the right level, so there is no chance of a financial bubble, defined by Peter Garber in his book “Famous First Bubbles” as a high price “at odds with any reasonable economic explanation”. Efficient markets have become an article of faith in some corners of the financial markets. If a price goes to a level for which there is no obvious economic explanation, the believer will simply conclude that there is a non-obvious economic explanation—such as the coming of a more productive “new economy”. What he will not conclude is that there is a bubble.

One illustration of how believers in efficient markets think is the debate about accounting for managers' share options, which has been revived by Enron's collapse. Share options are clearly a cost of employment, an alternative to paying cash. So it would seem to make sense to allow for the cost of the options before calculating a company's profits; but American accounting rules require merely that the options be disclosed in a footnote, not passed through the profit-and-loss account. Efficient-market adherents believe that a footnote is all that is needed, because the market is perfectly capable of subtracting the cost of the options from stated profits when calculating true value. As Holman Jenkins, writing recently in the *Wall Street Journal*, put it, “In the real world, any information, as long as it is deemed relevant, will be processed into the mill for pricing securities. It doesn't matter whether the data is computed into the income statement, or appears in a footnote, or is shouted up and down Wall Street by a man in a tutu.” On the other hand, the fact that senior managers are fighting so hard to stop the cost of their options being set against profits suggests that they, at least, do not think the market is as efficient as all that.

A growing number of economists have turned against efficient-market theory, at least in its extreme “no bubbles” version. One weakness in the theory is its assumption that arbitrage by the informed against the uninformed is riskless and costless. Shorting shares involves borrowing a share and selling it now in the hope of buying it back later at a lower price to return to the lender. But borrowing a share can be costly, especially if the price continues to rise for a while before it falls. The further it goes above the price at which it was sold, the more nervous the lender will get, and the more collateral he will want the borrower to post as security.

Perhaps the most famous example of the cost of arbitrage becoming unbearable was the collapse of Long-Term Capital Management in September 1998. LTCM was betting on the prices of various securities

moving closer together, because it believed the true value of different pairs of securities was the same. In the event, many of these prices headed further apart, often much more so than at any point in the past. Later, the prices did move in the direction predicted by LTCM, and would have produced a handsome profit for the company had it been able to hold its positions for long enough. However, when the prices first diverged, the net market value of those positions dropped so much that some of the counterparties of LTCM trades feared it would go bust. They therefore required ever more collateral or became reluctant to do business with LTCM at all. In the end the Federal Reserve had to organise a rescue by several big banks.

At this point, it should have become clear that markets were not as efficient as the theorists claimed. After all, two of LTCM's founders had won the Nobel prize for their work on another cornerstone of modern finance, options-pricing theory. In fact, their fate did not stop millions of people getting caught out soon afterwards when they bought hugely overpriced Internet shares. A fascinating study of the dotcom bubble by Eli Ofek and Matthew Richardson of the Stern School of Business further illustrates the limits to arbitrage. With many of the dotcom companies, the authors point out, the number of shares in circulation was very small. There were not enough available to borrow to meet the demand from would-be shorters. Given that in practice the scope for arbitrage is limited, it is quite possible for people with inaccurate valuations to set prices, and for these prices to get way out of line.

Strikingly, once post-IPO lock-up restrictions on selling by corporate insiders ended, prices often fell sharply—perhaps partly because well-informed investors were able to communicate their knowledge to the market by shorting.

A growing number of economists have become adherents of “behavioural finance”, which attempts to explain real-world deviations from the asset prices predicted by modern finance using the insights of human psychology. One example is that people often use a “representative heuristic”—that is, they use data from the recent past as a basis for predicting the future. Thus, when share prices have risen strongly in the recent past, perhaps for a good reason such as a fall in interest rates, investors may assume that they will continue to rise. They will therefore buy the shares, making their rise a self-fulfilling prophecy, at least for a while.

If current share prices reflect a belief that the returns on shares earned in recent years will be repeated in future, they are probably mistaken. The average share-price-to-profits ratio of American equities—as well as British and some continental European ones—remains high by past standards. Jay Ritter, an economist at the University of Florida, estimates that shares might reasonably be expected to earn around one percentage point more per year than the risk-free rate of interest. That would be far less than the average return on shares during the past 20 years.

In “Triumph of the Optimists: 101 years of Global Investment Returns”, Elroy Dimson, Paul Marsh and Mike Staunton of the London Business School also question whether future returns will match those of the recent past. The global post-war bull market in shares, they say, owed much to two trends that cannot be relied on to continue. First, the world enjoyed a long period of relative peace and prosperity far exceeding expectations at the end of the war. Second, equity holders increasingly diversified their portfolios, which led them to regard their shares as less risky and therefore more valuable.

Physics envy

Why do so many people cling so hard to the notion of efficient markets? Andrew Lo, an economist at MIT, suggests that they may be suffering from a “peculiar psychological disorder known as ‘physics envy'...We would love to have three laws that explain 99% of economic behaviour; instead, we have about 99 laws that explain maybe 3% of economic behaviour. Nevertheless, we like to talk as if we are dealing with physical phenomena.”

There may be some truth in this. In 1947 Paul Samuelson, later awarded the Nobel prize for economics, set out to apply the principles of thermodynamics to economics. More recently, Bill Sharpe, another Nobel-prize winner for his contribution to modern finance, wrote an interesting paper on “Nuclear Financial Economics”, drawing parallels with nuclear science. This work yielded some useful insights, but left a lot of question marks.

Emanuel Derman of Goldman Sachs, one of the growing number of former physicists working in investment banking, puts the financial world's physics envy into perspective. “There is no fundamental theory in finance. There are no laws.” In finance, he says, you are playing against people, who value

assets on the basis of their feelings about the future. “These feelings are ephemeral, or at best unstable.”

The art (not science) of valuing shares may be getting harder because of changes in the nature of the economy, creating even greater scope for bubbles to form. When the bulk of a company's assets were physical and its markets were relatively stable, valuation was more straightforward. Now a growing proportion of a firm's assets—brands, ideas, human capital—are intangible and often hard to identify, let alone value. They are also less robust than a physical asset such as a factory. As Enron showed, a reputation for trustworthiness, and the market value resulting from it, can vanish in a moment. The dotcoms pushed this valuation challenge to extremes, often expecting investors to put a price on profits that would not be forthcoming for many years, and would be derived from business models and intangible assets such as brands that had not yet been created.

To pop or not to pop

But back to Mr Greenspan. Messrs Smithers and Wright, having dispensed with market efficiency and established that asset bubbles are possible, next take issue with the Fed chairman's belief that central bankers are supposed to control only inflation, not asset prices. They argue that the downside of a bubble bursting—possibly some combination of depression and deflation—far outweighs the cost of raising interest rates to stop the bubble forming in the first place.

The Fed does take asset prices into account in its policymaking, but only in so far as changes in them are transmitted to demand in the economy and thus potentially affect the rate of inflation. The likely transmission mechanism is the “wealth effect”. As share prices rise, people feel better off and spend more; as they fall, people feel poorer and spend less, reducing inflationary pressure.

In practice, Mr Greenspan has seemed to act on the wealth effect only after share prices have fallen. For instance, when prices tumbled after the collapse of LTCM, the Fed cut interest rates sharply, and shares started to recover at once. This has given rise to the notion of a “Greenspan put”: just as an investor can set a floor for the price of a security by buying a put option, so Mr Greenspan will provide a floor for the stockmarket by cutting interest rates when it gets too low for his liking.

Whether or not there is really a Greenspan put, there is certainly no “Greenspan call”, or ceiling on share prices that would trigger a rise in interest rates. Should there be? It would be a risky strategy. Typically, bubbles begin when something has happened to make people feel more optimistic about the economy—say the building of the railways, or hopes of a new economic paradigm. This optimism might prove quite persistent. Small rises in interest rates might not be enough to burst such bubbles. Indeed, they might reinforce them by creating small falls in prices that provide “buying the dip” opportunities. To be sure of bursting a bubble permanently, a central bank might have to impose huge rate increases, with unpredictable and potentially severe economic consequences. That would make sense only if it could be quite sure that it really had a bubble on its hands that needed to be pricked.

There are various guides for judging whether shares are overvalued, including the ratio of share price to earnings and Tobin's Q, which shows the ratio of a firm's market value to its book value. But the only time anyone can be reasonably certain that there has been a bubble is after it has burst, and even then there could be an element of doubt. Some efficient-market proponents might argue that high share prices reflected fundamental value up to the moment they plunged, and continued to do so afterwards, because the change in valuation had been a rational response to new information coming to light. It would be hard to prove them wrong.

Given that a central bank could never be 100% sure at the time that there is a bubble, would it be justified in trying to burst it if it were 80% sure? Or 40%? This is a tricky question, and not just because raising interest rates would be unpopular; if it were raising rates to control inflation, it would willingly bear that burden for the sake of the economy. Keeping inflation under control does not challenge people's judgments; by maintaining the real value of the currency, it actually helps them to be confident that a price means what it appears to. By contrast, asset prices reflect the free judgments about value made by millions of people who have backed those judgments with their own money. Who is a central banker, even one as wise as Mr Greenspan, to say they are wrong? Should he be free to use heavy monetary artillery to make them change their minds? Probably not without a popular mandate.

In praise of bubbles

Besides, some economists argue that bubbles are really not so bad. They tend to coincide with periods of innovation that make society better off, even if they do not generate much profit for the innovators. The Internet, for instance, may have cost investors a fortune, but it has been a boon for its users. Policies that would be effective for preventing or pricking bubbles might also kill the underlying innovation.

Brink Lindsey, author of “Against the Dead Hand”, a robust defence of free markets, argues that the dotcom bubble was more of an example of “messy Schumpeterian creative destruction exploring a new technology than a structural problem”. The potential of e-commerce has been explored faster and more thoroughly “thanks to America's open-market system than had it been done by Japan's MITI [Ministry of International Trade and Industry] or a bank-financed system”. The bubble represented a “fast-forwarding of experimentation”.

Looking back, both the aftermath of the 1929 stockmarket crash and the bursting of the Japanese bubble were bad enough to justify paying a high price to avoid a repeat. But in both instances the authorities made glaring policy errors, including keeping interest rates high for far too long and, in Japan, refusing to acknowledge the extent of losses caused by the bubble bursting, let alone cleaning them up. There is no obvious reason why other central banks should repeat these mistakes. Alan Blinder, a former vice-chairman of the Fed, observed a little while ago, when the economy was still looking much bubblier than now: “For the US economy to go into a significant recession, never mind a depression, important policymakers would have to take leave of their senses.” We shall see.

Bubbles might be rarer if investors had accurate data on which to base their decisions. But even after Enron, what are the chances of that?

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Think of a number

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Accountancy used to be boring. If only it still were

ALL through the long equity bull market, it was considered bad form to say anything nasty about General Electric. The stockmarket suspended its usual dislike of conglomerates to make this one of the world's most valuable firms, cheek-by-jowl with Microsoft. Jack Welch, its combative chief executive (now retired), was lionised by the business press. When the European Commission dared to block the company's acquisition of Honeywell because of plausible antitrust concerns, policymakers in Washington, DC, muttered about a trade war on America.

So an article by the head of America's biggest bond-fund manager, published in March, came as a shock. Bill Gross, of PIMCO, argued that GE's management had "not been totally forthcoming" about how its profits had managed to grow at "nearly 15% per year for several decades". He noted that the firm had lots of debt, giving it "near hedge-fund leverage". Without this leverage, its operations resemble "the failed conglomerates of yesteryear".

None of this information was exactly new. The days when GE's accounts were taught at business schools as examples of conservative best practice were long gone. Mr Welch, it had become clear, liked to "smooth earnings" to deliver remarkably steady growth quarter after quarter, year after year.

On the fiddle

What was new was that Enron, which had appeared to be a highly profitable company until recently, had gone into bankruptcy after it was discovered to have cooked its books. The reason why GE's shares have fallen sharply in recent months is that investors have rumbled that, to a greater or lesser extent, much of corporate America has been fiddling its accounts, and GE is a prime suspect. Nor are American companies alone in this: other countries' accounting rules too offer plenty of opportunity for manipulation. After the Enron debacle, scores of companies with "accounting issues", especially those that smoothed their earnings, have seen their shares tumble. Investors used to reward firms that showed steady profit growth because they disliked volatility. Now they think smooth means fake, and are demanding the truth.

Back in the 1950s, companies prided themselves on the conservatism of their accounting. What changed their mind? One factor was the rise of inflation, which widened the gap between a company's book value on its balance sheet and its market value. Companies could book a profit simply by selling an asset at the higher current price and pocketing the difference over what they had paid for it. A second factor was the emergence of new sorts of assets and liabilities, says Baruch Lev, an accounting professor at New York University's Stern School. A third was the evolution of the modern firm and the blurring of corporate boundaries. Joint ventures, leasing and special-purpose entities all made it harder to determine whether a particular activity should be consolidated into a company's accounts.

The growing use of derivatives and off-balance-sheet financing and the rising importance of intangible assets such as brands and goodwill have all posed challenges to traditional accounting, none of which has been resolved entirely satisfactorily. And serious distortions have been introduced because share options awarded to employees, clearly an employment cost, are not charged against profits. In America, the Fed reckons that this has caused profits to be overstated by an average of 2.5 percentage points a year over the past five years.

There has also been a growing trend to take huge write-offs, and then announce pro-forma profits that supposedly reflect the firm's normal business activities. AOL Time Warner recently wrote off $60 billion related to acquisitions it overpaid for. JDS Uniphase has written off $51 billion in goodwill and intangibles.

This can be helpful in several ways. First, if a write-off turns out to have been too large—which may have been the intention all along—some of it can be reimbursed later, directly adding to profits. Second, the firm can pick more or less whatever number it wants for its pro-forma profits. Ostensibly, these are the profits generated by normal business operations, ignoring non-recurring items such as write-offs. In the first three quarters of 2001 the 100 biggest Nasdaq firms reported pro-forma earnings of $20 billion. For the same period, they reported losses under America's Generally Accepted Accounting Principles (GAAP) of $82 billion.

It all depends

Over the years, accounting-standard-setters responded to these changes in the business environment at different speeds and in somewhat different ways. America's GAAP, produced by the Financial Accounting Standards Board (FASB), tends to involve minutely detailed rules, spelling out precisely how a specific item is to be treated. By contrast, Britain's Accounting Standards Board, and latterly the International Accounting Standards Board, have tended to set out broader principles, leaving it to the accountants to work out how these apply to a particular item.

America's approach has fostered “a technical, legal mindset that is sometimes more concerned with the form rather than the substance of what is reported”, in the words of Joseph Berardino, until recently boss of Andersen, Enron's auditor until it went bust. America's litigious environment reinforces this emphasis on playing by the rule book and not questioning whether the rules actually provide useful information.

In Britain, some accountants feel that their country's broader, less pedantic approach would have prevented an Enron-like disaster. They also point out that Britain has much tougher rules than America to limit the creation of off-balance-sheet special-purpose entities. But Sir David Tweedie, chairman of the International Accounting Standards Board and former head of Britain's Accounting Standards Board, is sceptical. “History is full of people who said ‘it couldn't happen here' and came to regret it,” he says about Enron. “I do not plan to repeat that mistake.”

For all their differences, accounting rules everywhere have become much more complex as rule-makers have responded to changes within firms and have tried to close loopholes. Martin Whitman of Third Avenue Funds, a veteran investor, agrees that today's accounting is complex. But he blames this on the desire of accounting-standards-setters to meet the needs of the average investor—who tends to be obsessed with getting one “true” number, such as quarterly profits or cashflow per share from normal operations. Enron catered for that obsession, writing in its annual report that it was “laser-focused on earnings-per-share growth”. This Mr Whitman regards as folly: “GAAP can never produce a statement of true earnings.” He wants accounting to pursue a simpler goal, full disclosure, by providing plenty of useful information—“not truth”—so that trained analysts can judge the financial health of a firm for themselves. Deciding what the numbers in the accounts mean should be up to the users, not those who prepare them.

According to Mr Whitman, even with today's complexity, company accounts will tell seasoned analysts most of what they need to know. This may have been true even of Enron, if only people had cared to look. In a recent article, “Did Enron's Investors Fool Themselves?”, Chris Higson of London Business School argues that the information in the firm's published accounts should have set warning bells ringing long before the share price started falling. In particular, its operating return on capital and its return on equity declined sharply during 1996-2000, falling below the economic cost of capital. In other words, the publicly available data showed that the company was operating at a loss, says Mr Higson.

Jack Ciesielski of the *Analyst's Accounting Observer*, a suddenly much-followed journal, agrees. He sees “a crisis on the user side of accounting too. There is a ton of good disclosure out there that nobody is getting excited about.” Disclosure in Enron's books was incomplete, but there were plenty of footnotes that should have given analysts “a knot in the stomach”.

Hidden meanings

None of this is to say there is no need for reform. “Accounting is being asked to do something it was never meant to do,” says Robert Merton at Harvard Business School. “It is like a road system built for when cars did 30mph being used by cars doing 60—and then we wonder why there are accidents.” In particular, accounts simply provide a snapshot of a company that gives no indication of the firm's exposures to different sorts of risk in the future.

The concern is not just about the derivatives and other financial engineering that firms increasingly use. Even the treatment of, say, the assets and liabilities of a company's defined-benefit pension fund can be hugely misleading. Assume the pension fund has assets with a current market value of $100 billion. If the assets consisted entirely of shares, the fund would be much riskier than if they were all Treasury bonds. Yet the accounts would simply record the $100 billion, offering no clue about the level of risk.

This matters, because the assets of a defined-benefit fund are used as collateral to ensure there is enough money to pay pensioners. The collateral would be needed only if the firm did not have enough money to meet its legal obligation to deliver on its pension commitments. That is more likely to happen during an economic downturn, which might well coincide with low share valuations. Thus, if the pension-fund assets were in shares—especially the firm's own shares—the collateral would be at its least valuable just when it was needed most.

A typical balance sheet is full of such oddities. Mr Merton's solution is for companies to include something similar to the banks' value-at-risk (VAR) measures in their accounts, which would make investors aware of the potential for big shifts in a firm's net assets. Certainly, VAR is not perfect even for banks because the models often ignore the possibility of a truly bad day. It may be even less perfect for assessing the risk in corporate balance sheets because it is hard to gauge the value and potential price volatility of assets that are rarely or never traded. Yet for all its flaws, it is “a damn sight better than what we have now in the corporate sector,” says Mr Merton, who lived at close quarters with VAR during the crisis that brought down the hedge fund he co-founded, Long-Term Capital Management, and is adamant it was not to blame.

Number-crunch time

Immediately after Enron went bust, hopes were high that America would become disenchanted with GAAP and abandon its opposition to adopting the International Accounting Standards (IAS), opening the way to a single, worldwide set of accounting standards. This may happen eventually. But in the short term, the Americans are likely to resist the IAS and instead try to improve GAAP. At the same time the IAS—which currently are not quite as good as GAAP—will also be upgraded. These reforms may move in a similar direction. The incoming boss of FASB has served on the IASB, and the two bodies are likely to pursue a covert strategy of convergence on a common set of standards.

The IASB was reformed last year to make it less vulnerable to political pressures. It seems likely, therefore, that the reform of the IAS will proceed faster than that of GAAP, and that the IAS will, sooner rather than later, become superior to their American cousins. For instance, they will require the cost of share options to be charged against profits, which politics will probably prevent GAAP from doing. At that point, however, market forces will put huge pressure on America to upgrade GAAP to match the IAS, to avoid the risk of its firms and markets becoming uncompetitive internationally.

Already, Harvey Pitt, chairman of the SEC, has made it clear to the FASB that he expects it to do a better job, and has asked it to adopt tougher rules on off-balance-sheet special-purpose entities. The likely effect of this is that many of these entities will be reconsolidated on to balance sheets, particularly in the banking sector. Mr Pitt also wants firms to try harder to bring relevant information to the market at the earliest opportunity. He wants to go further than regulation “fair disclosure”, introduced by his predecessor, Arthur Levitt, which required firms to release material information to small punters at the same time as to professional investors. Mr Pitt wants firms to have a positive obligation to disclose. He also wants them to use plain English in describing their circumstances and prospects. This is wholly at odds with current practice.

Moreover, Mr Pitt has asked firms to spell out the main assumptions on which their accounts are based, and to state what the results would have looked like on a different set of assumptions. This is a small but welcome step in Mr Merton's direction, giving investors a better sense of the sorts of risks to which a firm is exposed. However, this sort of information is more likely to appeal to professional analysts than to small-time investors, who will continue to search for the single, simple truth about corporate profits. In reality, there is no such thing. Managers will always have a measure of discretion over the way they

present their figures.

That said, there is nothing in the present rules to stop managers from giving an accurate account of their company. But do they have the will, and are there enough incentives? It would certainly help if the market rewarded companies that provide full disclosure. Equally helpful would be good corporate governance. But that is another story.

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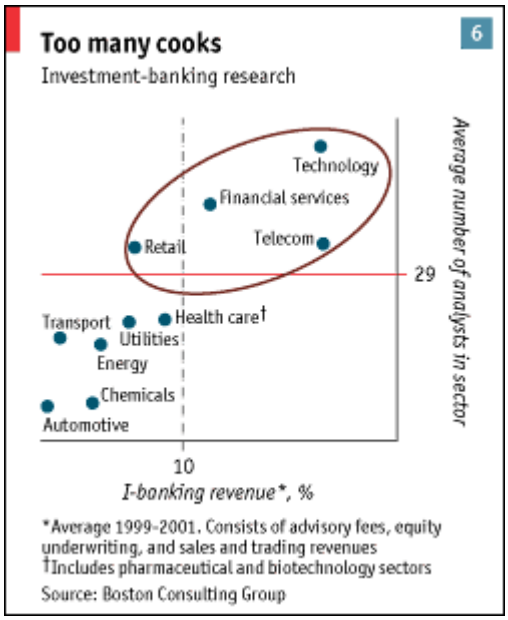
Is greed good?

May 16th 2002
From The Economist print edition

Only if it is properly governed



“THE chairman of your [board's] compensation committee should be richer than you and older than you,” one of America's most admired bosses advised a private gathering of 50 chief executives in New York last November. “That way, he won't get jealous when you make your fortune. In fact, he should be someone who loves to see other people get rich. Under no circumstances should he be from the public sector, or a professor.” Another boss provoked groans when he confessed: “I once made the mistake of giving the job to a distinguished academic.”

“Greed, for lack of a better word, is good. Greed is right. Greed works.” This credo by Michael Douglas, as Gordon Gekko in the 1987 film “Wall Street”, seemed to capture the spirit of the decade, with its sharp-suited investment bankers using mountains of debt to buy up sleepy old companies, fire most of the workers and make themselves a fortune. But compared with the past ten years, the greed of the 1980s was as nothing. And whereas the 1980s story was all about greedy Wall Streeters battling against company bosses who wanted to preserve their firm and its traditional values, in the 1990s a shared greed nurtured a symbiotic relationship between Wall Street and company bosses that made rich men (and, increasingly, women) of them all.

The case for greed was perhaps best made over 200 years ago by Adam Smith, who argued that the invisible hand of market forces would ensure that the efforts of individuals acting in pursuit of their own self-interest made society as a whole better off. In other words, judge capitalism not by the motives of the capitalists but by its fruit. Until recently, the fruit of the 1990s double act of investment bankers and company bosses looked both tasty and abundant, especially in America, where greed was given the freest rein. The economy grew more rapidly, productivity increased faster and the jobless rate fell further than anybody had thought possible. Profits soared, as did the stockmarket, spreading wealth to investors of all kinds, from fat-cat managers with share options to ordinary workers with stakes in retirement funds. It all seemed ample vindication for those real-world 1980s Gekkos (Ivan Boesky, Michael Milken, Henry Kravis et al) who argued that the way to ensure that corporate America created wealth for shareholders was to give management a piece of the action.

Doubts started to creep in first with the popping of the dotcom bubble, then with the broader drift in share prices and the economic downturn. In America, the ratio of households' net worth to income has fallen back to 5.3, down from its 1999 peak of 6.3, though still well above its long-term norm of 4. The optimists ascribe this simply to the ups and downs of the business cycle, and there is some truth in that. Yet for all the virtues of America's style of capitalism, many of the recent problems were the natural result of bad incentives. If the current slowdown changes those incentives, it will achieve something useful.

The wrong carrots

Managers' share options were supposed to solve the “agency problem” at the heart of the modern shareholder-owned company. The trouble with having owners who are not managers, and managers who are not owners, is that the managers, as agents of the owners, may not run the firm in the best interests of the shareholders. Handing the managers share options gives them a powerful incentive to put the interests of shareholders first. In the 1990s, when this idea gained widespread acceptance, options

spread rapidly through corporate America, and, less rapidly, in other rich countries too. What the theory did not allow for was that share prices could deviate substantially from their fundamental value, and that management could help this process along in the short term. The short term might be long enough for them to exercise their share options and sell the shares before the market caught on.

Options also happened to encourage behaviour that was good for Wall Street. In the 1980s, managers had often put up fierce resistance to their firm being bought, not least because they might well lose their jobs. But share options changed their incentives: because the options vest the moment a firm changes hands, they can make a takeover positively welcome to the managers. That suited the investment banks, which are constantly encouraging mergers and acquisitions because of the huge fees they generate—notwithstanding the lamentable economic record of most mergers. The managers at the firm that does the buying do not benefit from vesting options, but they are routinely offered another carrot: a huge bonus for pulling off the deal.

It is above all in America that company boards fail conspicuously to ensure that managers really serve the long-term interests of shareholders. This is not because board members cannot be bothered to do their job. Most big companies today work their board hard. Even so, board members rarely challenge the chief executive. If they do, they are often asked to resign, and usually oblige. As Enron showed, board loyalty may be encouraged with all sorts of incentives, including donations to favourite charities or consulting contracts. But even without such sweeteners, boards seem to have a natural inclination to turn into clubs, and nobody wants to upset the club president.

Divide and rule

Outside America, things are done somewhat differently. British boardrooms, for example, usually have a chairman, typically a non-executive, to balance the influence of the chief executive and run the board meetings. So the opinions being voiced can be more diverse, and the chief executive does not always get his way.

One idea for making boards more responsible is to hold them properly to account when things go wrong. Generally, board members face no financial penalties if they mess up because the company buys insurance for directors and managers. After Enron's collapse, Paul O'Neill, America's treasury secretary, floated the idea of asking chief executives to sign a financial-health statement that would make them liable for misrepresentations, whether deliberate or not. But the likely effect would be to make it impossible to get anybody to serve on a board. Already, the increased demands of board membership are discouraging chief executives from becoming non-executives elsewhere, says John Whitehead, a former boss of Goldman Sachs and a member of numerous boards over the years. “The risk is you will just get dignitaries who could use the $40,000 fee, college principals, public figures and the like. Boards may look socially responsible, but they won't act as a policeman.”

The big challenge is to ensure that two board committees—compensation and audit—do their job properly. In Britain, the Financial Services Authority has issued tough guidelines for the chairmen of audit committees of financial firms that might usefully be extended to other companies. But unless the chairmen of these committees are full-time, are able to hire their own professional advisers and, ideally, are nominated directly by shareholders, they are unlikely to have the knowledge and independence to be effective watchdogs, reckons Bob Monks, a veteran shareholder activist. He is not hopeful. Failing that, the best way of getting boards to work effectively is for chief executives to encourage robust debate and a culture of accountability. Alas, it is a rare boss who has so enlightened a sense of self-interest.

Proper rewards

If a compensation committee were working as it should, what would it do? For a start, it would reward only genuinely superior performance. If a firm's share price goes up for extraneous reasons—a fall in interest rates, say, or a rise in the stockmarket—why should the managers benefit? Rewards linked to a company's share price should probably be triggered only if the firm outperforms the market as a whole, or an industry peer group. And share options should not, as a rule, be repriced at lower levels if the firm's share price falls.

It may not be necessary to stop using share options (though actual shares are probably a purer incentive and have shown themselves to be effective in motivating managers). However, they do provide an incentive to boost the share price in the short run, which may not be in the company's best long-term

interest. One way to remove that incentive is to prevent the manager from selling the shares until some time after he has left the company, say three years. That is a long enough period for any trickery done on his watch to come to light. This need not do much damage to the manager's finances; a bank would be happy to extend a loan secured against the locked-up shares, provided it did not think their value had been artificially puffed up.

The biggest problem is to persuade the members of the compensation committee to care at least as much about rewarding the company's owners as they do about rewarding the chief executive who appointed them. The best answer may be to let the owners themselves vote on managers' compensation, especially options. Such a scheme is now being introduced in Britain. Mr Pitt of the SEC has proposed similar measures in America.

Before Enron's collapse, nobody much cared about audit committees or auditors. Now both are under fire. Strikingly, audit committees' most common response to growing scrutiny is to cover their backs. Many audit-committee reports this year have come with disclaimers to say that the accuracy of the firm's accounts are not their responsibility.

If anybody is going to take responsibility for a firm's accounts, it should be the external auditor. Following Andersen's humiliation at Enron, this duty is now being taken much more seriously. Yet serious conflicts of interest remain for audit firms that continue to do consulting work for audit clients. Andersen, notoriously, earned more from providing Enron with non-audit services than from the audit.

Given the crucial importance of the audit, everything possible ought to be done to eradicate any conflict of interest that might reduce effectiveness. Non-audit work for audit clients should clearly be prohibited. It would also be wise to introduce mandatory rotation of auditors after, say, five years, to stop auditor and client becoming too cosy.

Every crash has its villains, and this time public enemy number one is the Wall Street research analyst. Supposedly, analysts are another force for good corporate governance, putting pressure on management by providing investors with independent analysis of a firm's accounts and prospects. In practice, it seems, they often simply touted shares on behalf of the investment bank that employed them. This was particularly true of shares sold in IPOs. Investment banks earned huge sums of money from underwriting IPOs, and from other business relationships with companies. They typically earned little or nothing from selling research. No wonder the researchers often bowed to the investment bankers' demand for a buy recommendation to keep client firms happy.

According to the Boston Consulting Group, the potential for such tainted research was greatest in the technology, telecoms and financial-services industries, which contributed the lion's share of investment-banking revenues. As chart 6 shows, firms in these sectors had the largest number of analysts carrying out “research” into them.

Wall Street is worried that Congress will impose new regulations along Glass-Steagall lines to stop underwriting firms selling research. Erecting a new legal barrier of this kind might be a mistake, not least because to some extent this problem is curing itself. The IPO business is comatose and shows no sign of returning to the level of activity seen in the late 1990s. Investment banks are writing all sorts of new rules supposed to ensure the independence of their research, or at least give that impression. Examples include bans on analysts trading in the shares of companies they cover, disclosure of any investment-banking relationships with a company, and even making the occasional “sell” recommendation. Morgan Stanley has abandoned its system of buy and (rarely) sell recommendations for a set of ratings that offer only relative, not absolute advice.

Prudential Securities got out of investment banking altogether to prove its research is not biased. This is a brave move, because independent research firms have so far struggled to persuade anybody to pay for their work. Perhaps nobody really believes that having good research will help them to make money in the stockmarket.

Uncaring owners

In a speech earlier this year, Peter Fisher, a deputy secretary in America's Treasury, urged insurance companies and other institutional investors to get more involved in overseeing the management of the companies they invest in. Enron had highlighted the potential cost of neglecting to do so. “Corporate governance should be your risk-management programme for the next ten years,” he said. But will they

take any notice?

So far, institutional investors in America, who own so many shares that nobody could argue with them, have been shockingly indifferent to bad management. If they did not like what they saw in a firm, many simply took the old Wall Street walk and sold their shares. Even index funds, which did not have the option of selling, mostly did nothing to call underperforming firms to order. There were a few honourable exceptions, mainly public-sector pension funds—though even the most active of them all, CalPERS, failed to spot trouble coming at Enron; worse, it invested in one of its notorious off-balance-sheet partnerships.

Why is everybody being so discreet? Many of the biggest fund-management companies are hoping to win investment mandates from corporate pension funds and 401(k) plans, so they do not want a reputation for being troublemakers. Smaller funds may think they do not carry enough weight to make a difference, and that their time would be better spent on other things. Some may feel they lack the expertise to become involved in such complex matters. Robert Litan of the Brookings Institution, a think-tank, reckons there might be a market opportunity for a new firm that advises institutional investors on corporate-governance matters, ideally involving well-known public figures with solid reputations. Instead of trying to save Andersen from bankruptcy, perhaps Paul Volcker, a former Fed chairman, would have made better use of his energies by starting such a business.

Public pension funds started to take a greater interest in corporate governance in the mid-1980s after the government had told them that it was their legal duty to vote their proxies. The SEC recently issued a letter instructing mutual-fund companies that they also have a duty to vote proxies, which may trigger more activity from that quarter.

John Bogle, the former boss of Vanguard, the world's biggest manager of stockmarket index funds, recently proposed the launch of a federation of long-term investors, to cover index funds and other institutional fund managers which rarely sell shares. Just six firms between them hold some $1.4 trillion-worth of shares, around 10% of all shares outstanding. Such a federation would promote better corporate governance in order to boost long-term share values, says Mr Bogle.

A recent study of the relationship between corporate governance and equity prices in 1,500 firms in the 1990s found that better governance was correlated with higher returns. A strategy of buying shares in companies with good governance and selling the rest would have produced well-above-average results.

In the past, American capitalism has shown a remarkable ability to learn from its mistakes and emerge from them even stronger. The 1929 crash prompted the passing of tough investor-protection laws that greatly improved the quality of the financial markets. After America's savings-and-loan crisis and related property debacle of the late 1980s and early 1990s, the banking system was recapitalised and its risk management much improved. Perhaps now it is the turn of American shareholders to revitalise capitalism, by ensuring that the greed of their managers works with them, not against them.

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Better than the alternatives

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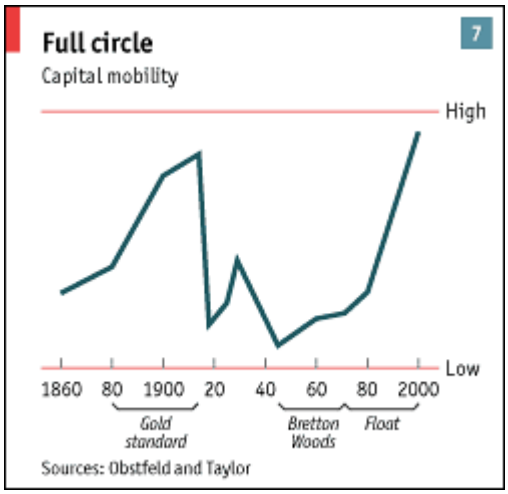
But capitalism needs nurturing, in poor and rich countries alike



JUDGED by international trade and capital flows and by the integration of markets, the world's economies were almost as globalised 100 years ago as they are now. Arguably, it was only during the past decade that globalisation got back to where it was at its previous peak, on the eve of the first world war. As chart 7 shows, between then and the end of the second world war, globalisation—as measured by capital mobility—went into rapid reverse as anti-capitalists took control of many countries, trade barriers went up and capital markets disintegrated. It was only with the demise of the post-war Bretton Woods fixed-exchange-rate system in 1971 that capital mobility started to rebound.

What lessons should be drawn from the move away from unrestrained capitalism during the first half of the past century? That it can happen, for one thing: capitalism can ebb as well as flow. That it has miserable economic consequences, for another, in rich and poor countries alike: the period when it was at its lowest ebb started with the 1929 Wall Street crash and continued through the Great Depression, probably not by coincidence.

World wars are clearly bad for global capital. So, too, are trade barriers, as capital often moves hand-in-hand with trade flows. Moreover, the globalisation of capitalism may already have peaked. Argentina's debt default, coupled with increasing hostility to foreign banks and capital, looks ominous to many observers. In terms of loans extended by foreign creditors, Argentina was by far the biggest emerging market. If it now submerges, what chance for other emerging markets?

Some economists and international investors have taken comfort from the absence of “contagion” from Argentina to other developing countries. This contrasts with 1997-98, when problems in Thailand spread throughout South-East Asia, and Russia's debt default caused knock-on problems first in Latin America and later in the rich world's debt markets. There has not been much of that this time; even Brazil, despite its close economic ties to Argentina, has suffered few ill effects on its domestic economy and has continued to tap the international capital markets.

Catching something nasty

Some economists are inclined to dismiss the notion of contagion altogether. But if there is such a thing as a financial-crisis virus, it is most likely to be transmitted by big international financial businesses, such as Wall Street firms and hedge funds. In 1998, emerging-market problems spread to rich-country debt markets via their effect on Long-Term Capital Management, a hedge fund that collapsed as a result, and on investment banks that had copied LTCM's investment strategy. International investors last year had much less exposure to Argentina and other emerging countries than in 1998 and, crucially, they were not caught by surprise, as they had been then when Russia defaulted. In financial markets, being able to prepare for bad news usually means it will end up less bad.

The reduced flows of capital from richer to poorer countries are a worrying sign. Some analysts have predicted that emerging markets will disappear as an asset class through lack of interest, although a recent rise in asset prices in those markets other than Argentina lifted the gloom for a while. In February CalPERS, a huge pension fund for public employees in California, announced it was pulling out of several emerging stockmarkets, starting with Thailand, Indonesia, Malaysia and the Philippines. Other funds may soon follow.

Compared with the previous peak of global capital, the amount of money flowing to poorer countries today is already small. Maurice Obstfeld and Alan Taylor, two economists, point out that less-developed countries' share of total global debt is at an all-time low. In 1900, these countries accounted for 33% of the total; in the 1990s, the figure was down to 11%. In 1913, the countries in the bottom fifth of income per person received around 25% of the world stock of foreign capital, much the same as the countries in the richest fifth. By 1997, the poorest fifth's share was down to under 5%, compared with 36% for the richest fifth. According to Messrs Obstfeld and Taylor, today's capital transactions seem to be “mostly a rich-rich affair, a process of ‘diversification finance' rather than ‘development finance'...foreign investment in the poorest developing countries lags far behind the levels attained at the start of the last century.” Why?

A decade ago, there seemed to be a simple formula for getting capitalism established in a country: bring inflation down, stabilise the exchange rate, create capitalist institutions such as a central bank and a stock exchange, and privatise as fast as possible. Now international investors have realised that sound public finances are also needed, says Richard Sylla, an economist at New York University's Stern School. Argentina was a case in point: its public-sector debt eventually became so large that international investors rightly lost faith in its ability to service it.

Nor did Argentina's pegged exchange rate do it any favours as the dollar appreciated and the Brazilian real depreciated. Although the peg to the dollar was strong enough to cause Argentina's economy enormous problems, it fell short of the total dollarisation embraced by some other Latin American countries, such as Ecuador, and could not prevent a devaluation that damaged Argentina's standing with investors at home and abroad. Argentina's large number of foreign-owned banks might have helped to protect its economy from domestic problems, but the government's treatment of these banks after the country's default undermined this potential force for stability. Corruption is also rife in Argentina, and there is concern that rapid privatisation often merely caused valuable state-owned assets to be handed to political insiders and crooks.

Two crucial ingredients in the successful transition to capitalism are political will and political effectiveness. These have often been overlooked, but that is changing, which may help to explain the lack of contagion after Argentina's default. Wall Street firms are waking up to the need to understand political risk. For example, Lehman Brothers has teamed up with Eurasia Group, a political consultancy, to produce political-risk indices for emerging economies. This kind of analysis can produce quite different advice from standard rankings based only on economic criteria. According to Ian Bremmer of Eurasia Group, “Investors are starting to understand that economic reform depends on the politicians promoting it remaining in power.” If international private capital (which in most emerging economies is far more important than aid or loans from international financial institutions such as the World Bank) goes to countries that offer a combination of good politics and good economics, it will send a powerful signal.

Essential ingredients

A society's ability to adopt capitalism also depends heavily on its culture and its legal framework. That is particularly true of market-based capitalism as practised in America, which has increasingly been regarded as the superior model—at least until Enron went bust. Strong investor protection is crucial. So, too, are legal rights to property that treat everybody fairly rather than merely protecting the rich, as Hernando de Soto explained in his book, “The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else”—still the best book on the subject.

According to Ira Millstein, a lawyer at Yale's International Institute for Corporate Governance, market-based capitalism seems much more likely to take root in countries with a legal system based on English common law and with an independent judiciary. It seems to fare less well in countries with legal systems based on European civil law, particularly the French version of it. Common law is more flexible and quicker to adapt to change, provides stronger investor protection and is less likely to sanction heavy-handed state intervention. But it will be difficult for civil-law countries to move in that direction, says Mr Millstein. “You can't just become a common-law system overnight.”

America will have a big part to play in establishing capitalism in the developing world. The terrorist attacks of September 11th appear to have energised the Bush administration to try to spread capitalism as widely as possible. The thinking behind this is that as countries get wealthier, and the wealth is shared by larger numbers of people, they become less likely to provide a breeding ground for terrorism.

One priority will be to lean on the big international financial institutions, notably the IMF and the World

Bank, to do a much better job. Over the years these institutions have often handed out poor advice and squandered many billions of dollars on loans that helped governments to postpone necessary economic and political reform. Against that background, the IMF's decision to stop lending Argentina any more money late last year, which made the country's default inevitable, may be seen as progress of a sort. The $250 billion lent by the IMF during the previous seven years to rescue countries from a variety of crises may have created a moral hazard, convincing borrowers and lenders alike that they would always be bailed out.

The World Bank has achieved little for its $500 billion of loans during the past half-century, besides saddling very poor countries with huge debts that should now mostly be forgiven. Its own internal review in 2000 found that, of the projects it had sponsored in the poorest countries, barely one in three had achieved acceptable results. It is hard to imagine worse results from America's latest proposal for the World Bank to switch from lending to making grants, subject to performance targets being met.

Establishing a successful capitalist economy in an Arab country would be a particularly precious prize, but so far this has proved elusive. America seems to have settled upon Turkey as the next best thing, encouraging the IMF to treat it much more kindly than it did Argentina. Arabs made wealthy by oil seem to understand enough about capitalism to invest most of their fortunes in America and Europe, but not to allow it to operate at home. Benn Steil, an economist at America's Council on Foreign Relations, points out that the wealth of Osama Bin Laden's family came from the monopoly it was given over much of the construction sector in Saudi Arabia—the “sort of state-fashioned monopoly that dominates the economic landscape across most major sectors throughout the impoverished Arab Middle East”.

A better class of capitalism

Compared with the problems of the developing world, the weaknesses in American capitalism revealed by the Enron debacle or the dotcom bubble may seem minor. But this does not absolve America and other rich countries from putting their own house in order. The financial system has proved surprisingly resilient during the recent shocks, but there is no guarantee that it will remain so in future. The crucial role played by accounting and auditors in a capitalist sytem needs to be recognised, and legal safeguards put in place to ensure that they play it properly. If this increases the cost of auditing, then it is a price worth paying. Above all, shareholders—particularly big institutional investors—need to accept the responsibilities that come with ownership. If they do not insist on the highest standards of integrity in the running of their companies, no one else will.

Capitalism, like democracy, may not be perfect, but it beats the alternatives. And making it as good as possible will advance the future prosperity of us all.

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Acknowledgments

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Recommended reading

Many books touch on the themes in this survey. In addition to those cited in the survey (see below) among the more interesting are:

"In Defense of Free Capital Markets: The Case Against a New International Financial Architecture", by David Derosa. Bloomberg. This examines many of the most publicised recent crises in the markets and suggests that these were not as troubling as they seemed, or owed more to bad government policy than market failure.

"The End of Globalisation. Lessons from the Great Depression", by Harold James. Harvard University Press. An essential guide to how to avoid repeating a particularly nasty phase of our economic history.

"Dot con. The greatest story ever sold" by John Cassidy. Harper Collins. A comprehensive instant history of the dotcom bubble.

"Fooled by Randomness: the Hidden Role of Chance in the Markets and in Life", by Nassim Taleb. Dimensions. A fascinating treatise by a trader on the role of luck in markets, and how we often confuse it for skill. This error lies at the heart of many a market bubble.

"The Global Financial System: A Functional Perspective", by Dwight Crane, Ken Froot, Scott Mason, André Perold, Robert Merton, Zvi Bodie, Eric Sirri and Peter Tufano, eds. Harvard Business School Press. A superb analysis of how the financial system is evolving by a collection of leading thinkers in academic finance. A difficult read, but worth it.

"The Free-Market Innovation Machine", by William Baumol. Princeton University Press. A leading economist explains why capitalism is best. A brilliant, readable theoretical explanation of how market forces in a capitalist economy generate innovation which in turn produces economic growth – and why other economic systems fail to do as well.

"Reinventing the Bazaar: a Natural History of Markets", by John McMillan. Norton. Highly readable tour of the world's markets, explaining how they work, why they sometimes do not, and how they are evolving.

"The Money of Invention: How Venture Capital Creates New Wealth", by Paul Gompers and Josh Lerner. Harvard Business School Press. A serious study of the start-up arm of the finance industry – venture capital - which was celebrated during the dotcom bubble, and vilified after it burst.

"George Soros on Globalisation", by George Soros. Dimensions. A billionaire hedge fund investor's fears for the global financial system, and his proposals to make it work better, especially for the poor.

"Globalisation and its Discontents", by Joseph Stiglitz. W.W. Norton. $24.95. A Nobel prize-winning former chief economist of the World Bank argues that globalisation can be a powerful force for good, but to achieve its potential, especially for the poor, the global governance institutions – IMF, World Bank, WTO – must be reformed.

Further relevant articles from *The Economist* are recommended on the following topics:

Enron:

The amazing disintegrating firm, Dec 6th 2001

Wall Street after September 11th:

The markets rewired, Sep 20th 2001

Argentina:

A decline without parallel, Feb 28th 2002

Market bubbles:

Taking the measure, Nov 22nd 2001

Rethinking thinking, Dec 16th 1999

Bulls, bears and ivory towers, May 13th 1999

The abolition of America's Glass-Steagall act:

Conflicts, conflicts everywhere, Jan 24th 2002

The wall falls, Oct 28th 1999

Killing Glass-Steagall, Oct 28th 1999

The Basel bank capital accord:

The good tailors of Basel, Feb 21st 2002

Basel postponed, Jun 28th 2001

Sweeter Basel, Jan 18th 2001

Stronger foundations, Jan 18th 2001

Survey sources:

Introduction: Capitalism and its troubles

The Boston Consulting Group's report "Global Wealth 2002: Prospering in Uncertain Times", will be published on July 8th. A summary, plus details of how to obtain it, will appear on the web at bcg.com.

"Irrational Exuberance", by Robert Shiller. Princeton University Press. $15.95.

"Technology, information production and market efficiency", by Gene D'Avolio, Efi Gildor and Andrei Shleifer explores why a combination of the incentives of Wall Street, increased share trading by individuals and new technology have put accounting under strain and increased the risk of bubbles.

Crisis? What crisis?

The Bank of England's research into the impact on GDP of banking crises.

New dangers

An interesting article by Emanuel Derman.

A version of Avinash Persaud's article on "Liquidity Black Holes".

Warren Buffett's latest letter to shareholders of Berkshire Hathaway.

The Bank of England's Financial Stability Review, December 2001, has an article about credit risk transfer.

"Unsurety bonds" is a recent Economist article on banks and their surety bond troubles.

Unexploded bombs

Bert Ely's articles about the dangers posed by Fannie Mae and Freddie Mac are online.

The regulator who isn't there

Speeches by Howard Davies of the FSA are online. Of particular interest are ones on insurance, on Enron, on corporate governance and on having a single regulator.

The Centre for the Study of Financial Innovation provides an article on a single regulator and a collection of papers about the Basel capital regime.

The Bank for International Settlements provides articles on the riskiness of the financial system and on Basel. See also a speech by Andrew Crockett.

The story of Long-Term Capital Management is well told in "When Genius Failed", by Roger Lowenstein. Random House.

From *The Economist* see: "When the sea dries up**",** Sep 23rd 1999

Further thoughts from *The Economist* on the ratings agencies include:

"Quant argue with that", Feb 14th 2002

"Sovereign ratings", Oct 25th 2001

"Reluctant watchdogs", Jun 7th 2001

Bubble trouble

"The Economic Consequences of Alan Greenspan", by Andrew Smithers and Stephen Wright, appears in World Economics.

The Federal Reserve publishes Alan Greenspan's recent testimony to the Committee on Banking. His "irrational exuberance" speech is also online.

"Famous first bubbles" by Peter Garber. MIT Press.

"Coming clean on stock options", Apr 25th 2002, from *The Economist*, examines accounting for share options.

"DotCom Mania: the Rise and Fall of Internet Stock Prices", by Eli Ofek and Matthew Richardson.

Investor Home gives an overview of behavioural finance.

Jay Ritter's website contains many fascinating articles. For his calculation of the potential future returns from equities, see "The Biggest Mistakes We Teach".

"Triumph of the Optimists: 101 Years of Global Investment Returns", by Elroy Dimson, Paul Marsh and Mike Staunton. Princeton University Press.

Andrew Lo discusses physics envy.

Bill Sharpe's paper on "Nuclear Financial Economics" is online.

Andrew Smithers and Stephen Wright have written a book applying Q to today's stockmarket: "Valuing Wall Street: Protecting Wealth in Turbulent Markets". McGraw-Hill.

"Against the Dead Hand", by Brink Lindsey. John Wiley.

Think of a number

Bill Gross publishes a monthly market commentary on the Pimco website. GE is criticised in the March and April editions.

For more on the challenges facing accounting today, see "Intangibles: Management, Measurement and Reporting" by Baruch Lev. Brookings Institution. His website is also a valuable resource on this subject.

Sir David Tweedie provides comments on Enron. A speech by Paul Volcker focuses on the crisis in accounting.

Martin Whitman comments on the Third Avenue Valve Fund.

The Analyst's Accounting Observer is online.

"Did Enron's Investors Fool Themselves?" by Chris Higson, Business Strategy Review. Summer 2002.

Robert C. Merton's homepage contains useful information.

Speeches by Harvey Pitt are online. Of particular interest are these (click here and here).

Is greed good?

See further quotes from Oliver Stone's Wall Street.

The "invisible hand" appears in "The Wealth of Nations: An Inquiry into the Nature and Causes", by Adam Smith. Modern Library.

Details about the changing ratio of household net worth to income in America are available from the Federal Reserve.

Bob Monks has a website that is essential reading for anybody interested in corporate governance.

Peter Fisher's challenge to the insurance industry is online.

Robert Litan gives his thoughts about Enron and after.

John Bogle's speech is available on the website of his Bogle Financial Markets Research Center.

Better than the alternatives

"Globalisation and Capital Markets", by Maurice Obstfeld and Alan Taylor is online.

Eurasia Group's website contains useful information.

"The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else", by Hernando de Soto. Dimensions.

Yale's International Institute for Corporate Governance has information online.

Several cogent critiques of the World Bank and IMF can be found on the website of Allan Meltzer, an

economist at Carnegie-Mellon.

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May 16th 2002
From The Economist print edition

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Japanese shareholder activism

A clash over cash

May 16th 2002 | TOKYO
From The Economist print edition

A heated shareholder battle could change the way Japanese companies operate—if the right side wins

Mary Evans

WHEN Tokyo Style holds its annual meeting on May 23rd, its president will face a rare challenge from a new breed of Japanese investor. Yoshio Takano has run the clothing company since 1979, when he took the helm after rising through its sales force. The man who wants to rock his world is Yoshiaki Murakami, an ex-bureaucrat who now runs an aggressive investment firm, M&A Consulting. Mr Murakami, who has an 11.9% stake in Tokyo Style, is urging other shareholders to back a measure that, by Japanese standards, seems astounding. It would repudiate Mr Takano's strategy by demanding that he return a big chunk of their money.

Mr Murakami's case rests on simple arithmetic. Tokyo Style holds ¥122 billion ($954m) in cash and securities and has no debt, yet the stockmarket values its shares at only ¥107 billion. Investors, therefore, seem not only to expect no returns from the firm's fashion-peddling business, but also to believe that its shares are worth less than the cash in its vault. If they think that Mr Takano will waste their capital, they are making a reasonable guess. Many Japanese managers look on cash the way that America's gun lovers view their firearms: you can have it only when you pry it from their cold, dead hands.

If Mr Murakami wins this battle, other listed companies could soon land in investors' sights. Merrill Lynch reckons that over half of the companies in the top tier of the Tokyo Stock Exchange are trading, like Tokyo Style, below book value; many of these may have cash and securities worth more than their stockmarket value. The bank also estimates that profit-oriented investors (including trust banks, investment trusts, individuals and foreign funds) now own a greater proportion of those shares than do cross-holding banks and business partners who frequently prop up bad managers.

For decades, the task of overseeing Japanese companies has fallen mostly to their bankers, who tended to step in only when debts got out of hand. For a long time the system worked fairly well, partly because most firms thrived, and partly because the bankers played an active role in overhauling the few that did not. However, the banks' balance sheets, management skills and influence eroded rapidly in the 1990s. Although many struggling debtors still manage to win their forbearance—this week four creditors arranged a ¥470 billion rescue for Daikyo, a property developer—the banks are now less likely to sort out deadbeats' deeper business ills.

A variety of new investors hope to fill the void left by the bankers. At one extreme, a few distressed companies are voluntarily, albeit reluctantly, turning to new buyers to resolve their problems. Some are being snapped up by rivals: in 1999 France's Renault took a 36.8% stake in Nissan and then installed its own man to revive the car maker. Other troubled firms have attracted bids from private-equity funds, such as America's Ripplewood.

At the other extreme, a few healthy firms have willingly ceded some independence so as to boost the value of their shares. One of Japan's leading drug companies, Chugai Pharmaceutical, agreed in December to sell a majority stake to Switzerland's Roche.

Although both types of voluntary seller remain rare in Japan, these trends at least offer grounds for optimism. Yet between the two extremes lies another, much bigger group of firms, which continue to waste precious capital and resist oversight, but remain solvent enough to carry on as before. The best

hope for improving them is a stiff dose of hostility, such as the vote Mr Murakami has forced on Tokyo Style.

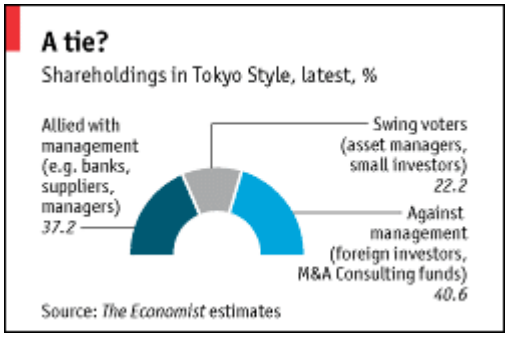
Hellraiser

As a bureaucrat, Mr Murakami worked on reforms in the late 1990s that were intended to pry open Japanese companies. He thought that the new rules would promote a wave of management buyouts and takeovers, much as happened in America in the 1980s. So in 1999, at the age of 39, he entered the private sector. But whereas most of Japan's former bureaucrats descend from heaven into cosy corporate postings, Mr Murakami started a new investment fund and proceeded to raise hell.

In early 2000 he went after Shoei, a cash-rich former silk company that had diversified into electronics and property. Although his takeover bid drew approval from 85% of independent shareholders, they accounted for only 30% of the firm's total shares. Shoei's banks, suppliers and other business partners held the rest, and rejected the bid.

After that snub, Mr Murakami changed tack. He and his partners sought out companies with lower levels of cross-shareholdings (which have been falling as banks unwind their holdings). They also stopped trying to take over companies, and instead looked for ones that a simple shareholder vote could help to redirect. After raising two new funds worth ¥60 billion, M&A Consulting invested in some of the mangiest dogs on Tokyo's stockmarket. The average firm in its portfolio is trading at just over half its book value, and has a cash pile equal to 30% of assets.

M&A Consulting has preferred to work quietly with these firms. Some have since taken steps to return capital to shareholders—but not Tokyo Style. Last summer, after Mr Murakami announced that he had bought a large stake, Mr Takano gave a rare interview to the Japanese press, in which he had this to say: “Our cash on hand is the result of steady efforts over 50 years. I don't understand why we should be subjected to criticism or demands for improvement.” Mr Takano added that Tokyo Style would spend the cash on ¥40 billion-50 billion of Tokyo commercial property, a sector in which he considered himself a novice.



Mr Murakami has other ideas. He is asking for a ¥60 billion special dividend, and a start to returning another ¥34 billion through share repurchases. Mr Murakami's supporters hold roughly 40% of the shares, as do Mr Takano's defenders (see chart). Mr Murakami is badgering local asset managers, who hold many of the remaining shares and have been sitting on the fence, to shake off their complacency and vote with their wallets. Mr Takano has raised the dividend a bit, in the hope of buying them off. On the latest odds, a giant step for Japanese capitalism still hangs in the balance.

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Energy trading

Prepare to be shocked

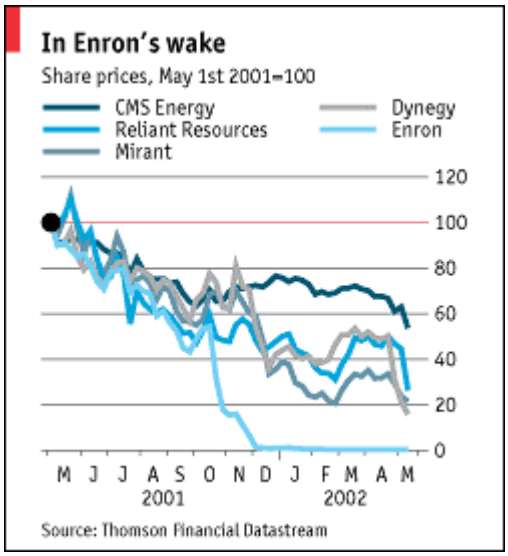
May 16th 2002 | NEW YORK
From The Economist print edition

America's energy traders are succumbing to Enronitis

EVER since Gray Davis, governor of California, locked his taxpayers into exorbitantly expensive, long-term electricity contracts at the height of California's energy crisis, his staff have worked tirelessly to pin the blame on somebody else. The collapse of Enron helped, in a general way, to divert attention. Until recently, however, the energy trader's bankruptcy had given little impetus to Mr Davis's allegations that energy traders had fleeced California by illegally manipulating energy prices. Now Mr Davis has found succour at last. Two new regulatory investigations and collapsing investor confidence have left the industry flat on its back.

On May 13th, Kaplan Fox & Kilsheimer and Wolf Popper, two law firms, filed suit in San Francisco against a number of energy suppliers on behalf of Californian taxpayers. The suit alleges that long-term power contracts have forced consumers to pay $9.1 billion more for energy than they would have done at "proper" market rates, and that over the next ten years the gap will be even bigger.

On the east-coast, a widening probe by the Securities and Exchange Commission (SEC) hints at broader price-rigging. Even free-market ideologues at the Federal Energy Regulatory Commission (FERC) have their noses to the political winds. On May 6th, the FERC released two memoranda, obtained from Enron's lawyers, that Mr Davis and his supporters say prove their allegations. With credit-rating agencies, shareholders and creditors running scared, confidence has collapsed across the industry (see chart). Such once-lauded companies as Reliant Resources and Dynegy (which almost bought Enron before it collapsed) are fighting for their lives.



The SEC's latest interest is in a practice known as "round-tripping". The round-trip starts with one energy-trading company selling electricity to another. The second firm simultaneously sells the same electricity, at the same price, back to the first. Reliant, one of five energy traders known to be under investigation, explains that its "rogue" traders used round-tripping to boost business artificially and make the company appear more successful than it really was. Reliant has discovered that, over the past three years, 10% of its trading revenues came from this sleight of hand. The rogue traders, it says, have now left the firm. Dynegy claims that its round-trip trading—with CMS Energy, a little-known rival—was done to test the ability of its trading system to handle large trades. CMS has admitted that 80% of its trades in 2001 were round-trips.

Round-tripping is not illegal in the energy markets, and inflates neither cashflow nor profits. But the markets find conspiracies in everything these days, and round-tripping has begun to acquire darker motives. Because the big energy firms trade between themselves over proprietary networks, there is no public price for electricity in this part of the market. The market price, says Gordon Howald of Credit Lyonnais Securities, is by definition the price at which the last trade took place. In theory, round-tripping could be used to set new, artificially high benchmark prices for electricity contracts. If this could ever be proved, the ensuing litigation would bury the industry.

The two Enron memoranda offer more evidence of the roundabout route that electrons take from power plants to households in America. Written in December 2000, when Californian businesses and households

were suffering widespread power shortages, the documents show how Enron and other energy firms profited from the deficiencies of California's “liberalised” power market.

Traders pursued two broad strategies. One wheeze was to create the impression of an imbalance in electricity supply and demand, and then to reap fees from state authorities for seeming to rebalance the system. The second, say the memoranda, was for Enron to “get paid for moving energy to relieve congestion without actually moving any energy or relieving any congestion.” To ensure that traders in on the game knew what monkey business was going on at any one time, Enron gave different trades different monikers, such as “Death Star”, “Get Shorty” and “Fat Boy”.

Other energy-trading firms, which are now also under investigation by the FERC, insist that they have done nothing illegal. That remains to be seen, although most of the behaviour described in the memoranda appears to be “gaming” a young and poorly designed system—making money from inconsistencies, as every good trader should.

Nobody, however, can deny the huge damage done to the industry's reputation. The Enron lawyer who penned the memoranda put his finger on it when he described how the firm had exported electricity from California at capped prices, and sold it for huge gain elsewhere: “This strategy appears not to present any problems, other than a public-relations risk arising from the fact that such exports may have contributed to California's declaration of a Stage 2 Emergency yesterday.”

The markets seem to have decided that this risk has since become overwhelming. With political fires roasting the regulators, the energy companies and their protectors in the White House, companies such as Dynegy, Reliant and Mirant are looking decidedly wobbly. As Enron proved in spades, a trading house lives and dies by its reputation. Expect more funerals.

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European pay-TV

Switching off

May 16th 2002
From The Economist print edition

Operators are closing or merging almost daily. Where will it all end?

ONE by one, Europe's loss-making pay-television companies are switching off. Last week, it was the turn of KirchPayTV to apply for insolvency. In recent weeks, the plug has been pulled on Quiero TV, a Spanish pay-TV operator, and ITV Digital, a British one. Two Spanish satellite-TV companies, Sogecable and Via Digital, have just announced a plan to merge, in the hope of stemming their losses. And a separate pair in Italy, News Corporation's Stream and Vivendi's Telepiu, are also struggling to cut their losses.

At first glance, this wave of bad news might suggest a European reluctance to adopt something that the Americans consider to be part of the furniture. Although roughly half of Europeans pay for their TV channels, many pay only a small sum to receive broadcast channels by cable. Premium pay-TV, of the sort supplied by Canal Plus or BSkyB, is bought by only around a fifth of European homes, compared with over four-fifths of American homes.

Certainly, some of the felled pay-TV operators failed miserably to persuade Europeans to sign up. Spain's Quiero, for instance, managed just 210,000 subscribers. Even Europe's leading pay-TV firms are losing money. In the first quarter of this year, Canal Plus made an operating loss of *euro*64m ($56m); BSkyB reported a pre-tax loss of £26.4m ($38m). With strong public-service broadcasters, and a wide choice of all-but-free channels, perhaps Europeans feel less need to pay for television.

In fact, the upheaval in European pay-TV has more to do with industry consolidation than with consumer disillusion. Pay-TV is still a fledgling industry. As Adam Bird of Booz Allen Hamilton, a consultancy, points out: “People forget that it took a long time for cable to establish itself in the US.” If consumers see a reason to pay, they will sign up: BSkyB, which has exclusive rights to top English football games, added a net 584,000 new recruits in the past 12 months, an extra 11%.

What is taking place, rather, is a shake-out. It is proving hard for any single market in Europe to support lots of operators. In Britain, four premium pay-TV businesses have already become three—and they could even shrink to two. In Spain, the choice could narrow from three to one. After the Italian regulator this week gave only conditional approval to a proposed merger of Stream and Telepiu, Vivendi said that it would seek to pull out of the whole mess.

Propelling all this consolidation is the fact that, without scale, it is hard for a pay-TV company to afford the investment in technology, the cost of acquiring subscribers—and, above all, the content needed to lure and keep them. Programming costs at BSkyB, for instance, were 26% higher in the nine months to March 2002, at £1 billion, than in the same period the year before. Overpayment for sports and movie rights was largely to blame for the collapse of KirchPayTV. A small operator in Europe's relatively small markets has little clout in negotiating content rights, especially for Hollywood films and TV series.

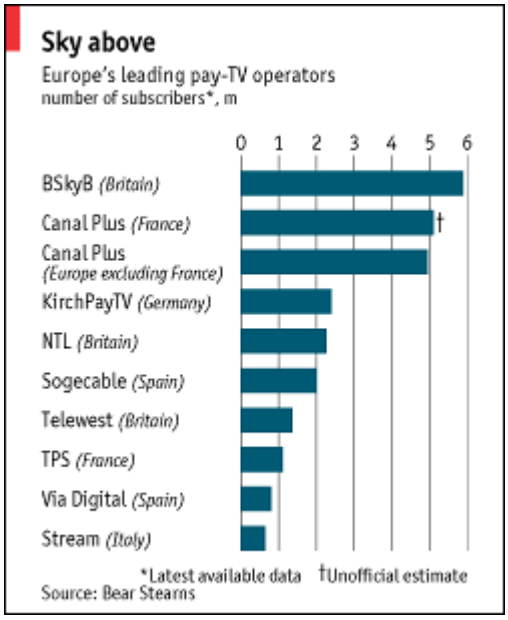
The survivors in pay-TV seem to be those who got in first. Newcomers, struggling to win subscribers, have found it hard to compete. So, in Britain, BSkyB, with its 5.9m subscribers, towers over its two rivals, NTL and Telewest; in France, Canal Plus soars above TPS; in Spain, Sogecable dwarfs Via Digital (see chart).

On top of all this, most of the upstarts were launched on the back of the spread of digital television, which broadcasters and telecoms firms saw as a way to break into pay-TV. Nick Bell of Bear Stearns, an investment bank, calls this the “Sky mirage”: the success of BSkyB's analogue operation, he says, “created the belief that a pay-TV oasis would exist for the taking in every

European country."

Yet the upshot was that the most powerful incumbents simply stepped up their own digital campaigns. BSkyB, for instance, began to hand out free of charge the digital set-top boxes needed to decode the satellite-TV signal. This destroyed the company's short-term profitability. But it kept BSkyB on top.

How far can consolidation go? So far, Canal Plus is the only pay-TV operator with premium services across Europe. BSkyB may not get its money back from its recent investment in Germany: this week it joined the queue of creditors to the crumbling Kirch empire, by exercising a put option on its 22% stake in KirchPayTV. But what of a BSkyB-Canal Plus combination? Rupert Murdoch, whose News Corporation controls BSkyB, proposed just such a deal a few years ago. It went nowhere—and Vivendi this week offloaded its 13% stake in BSkyB—not least because of French panic about selling to Mr Murdoch. With Vivendi's investors increasingly miffed that Canal Plus continues to lose money, could this be a good moment for Mr Murdoch to try again?



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Napster

The long goodbye

May 16th 2002
From The Economist print edition

The former file-swapping sensation is on its last legs

Get article background

AFP

Still available illegally

SO FAREWELL then Napster, icon of the anarchic days when music fans thrilled to the prospect of subverting the record-industry giants. This week, amid rumours that Napster was heading for collapse, Konrad Hilbers, its boss, and Jonathan Schwartz, a fellow executive, resigned. The online file-sharing service, whose illegitimate incarnation was shut down by a court last year, had hoped to relaunch as an official service with the backing of Bertelsmann, a German media group that owns BMG, a record label. But their failure to agree a deal, coupled with an outstanding lawsuit brought by the record industry against Napster, prompted this week's resignations. Napster, it seems, could soon be history.

On the face of it, Napster's demise represents the triumph of fat cats over humble music geeks. At its peak in February 2001, 1.6m people were swapping music files on Napster at any one time. By August, after the music giants had forced Napster to police illegal file-sharing, use had dwindled to nothing. Stung by the force of the black-market trade, the record majors set about devising their own official music-subscription services to mop up the business.

But two things have happened to sour their victory. First, Napster lookalikes—Gnutella, Audiogalaxy, KaZaA and others—have sprung up to enable underground file-swapping to continue much as before. In March this year, in Europe alone, where file-sharing is less prevalent than in America, illegal file-sharing services were used 11.3m times, according to Jupiter MMXI, a research firm.

Second, the music industry's efforts to lure music lovers to official services, such as RealOne Music and pressplay, have been disappointing. The record companies had argued that illegal file-sharing would stop once a comparable legal alternative was in place. But this is not what they have provided. Napster enabled users both to copy downloaded files on to a CD, and to transfer them to a portable music-player. The new services strictly limit what subscribers can do—they are, in effect, music-rental services, not record stores. Given that recent research by Jupiter MMXI showed that heavy online file-swappers were also more likely to spend a lot buying CDs in shops, this restrictive approach looks more than a little short-sighted.

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A German corporate raider

Part predator, part prey

May 16th 2002 | FRANKFURT
From The Economist print edition

German company? Listed? Shares looking cheap? WCM is watching

AMERICA has plenty of companies that sniff out stakes in underperforming firms and then try to influence how they are run. Europe is less well endowed. Germany, for instance, has no equivalent of Warren Buffett's Berkshire Hathaway. If any company comes close, it is a low-profile part landlord, part investment firm called WCM.

Founded as a textile manufacturer in 1766, WCM mutated after being bought in the 1980s by Karl Ehlerding, a professional investor. The firm was moribund, but it had property, undervalued in the books, and losses that could be set against future profits to keep the taxman away. Mr Ehlerding is still very much around, although no longer in day-to-day management. His family controls 46% of WCM.

As a landlord, WCM owns 54,000 flats, bought from German housing associations. As an investment firm, it buys and sells shares in other listed German companies. The two activities “have nothing at all to do with each other,” admits Roland Flach, head of the management board. “There are no synergies.” The point is the mixture of risks. The property business is low-risk; the equity side is riskier, but carries the promise of higher returns.

In WCM's Frankfurt office, opposite the city's stately opera house, around 30 people scan the stockmarket for “undervalued” shares among Germany's 100 or so biggest listed companies. Although it makes frequent small share-trades, WCM's forte is a sudden strike for a biggish stake. This has given it a name as a corporate raider, a label that Mr Flach rejects. Aware of its reputation, the company has offered lots of explanations for its latest coup, revealed in February: a 5.5% stake in Commerzbank, Germany's fourth-biggest bank. Because Commerzbank is a perennial subject of takeover rumours, this smelled like an opportunistic purchase in the hope of a bid, if not the prelude to a bid by WCM itself.

Not so, says Mr Flach: Commerzbank is simply a bargain, trading at below its book value. He likes what the management is doing, and especially its focus on serving German companies. WCM, he insists, is acting independently of Cobra, a group of investors that was once the bank's biggest shareholder and caused its management no end of trouble. At times Cobra made no secret of its wish for a generous takeover offer. WCM plans to bring the bank some peace and to keep its stake for two to five years, Mr Flach says.

WCM is not always so cuddly. Sometimes it buys whole companies and breaks them up, if it reckons the parts are worth more than the whole. In January 2001, it took control of Klöckner-Werke, an industrial group. A takeover was not always the plan: WCM bought 10%, then 25%, then 40% before making a bid that was resisted by the target's management. Last autumn, WCM sold Klöckner-Werke's industrial-films division to Cinven, a British private-equity firm, for *euro*925m ($820m). Further sales, probably including Klöckner's car-parts business, are planned.

As a trader in companies and their shares, WCM has to live with volatility: it does not expect 2001's profit of *euro*430m to be repeated in 2002. It must also live as it judges others, by its own share price, the more so because it habitually pays low dividends and for the past two years has paid none at all. After a roaring time in the late 1990s, the share price slid in 2000, weighed down by the battle for Klöckner-Werke, for which WCM paid in shares. Since then it has merely managed to match a lacklustre market. Is WCM itself undervalued? It thinks so. In that case, shouldn't it be a target too?

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Flags of convenience

Brassed off

May 16th 2002
From The Economist print edition

How the war on terrorism could change the shape of shipping

Reuters

Time to strike the colours?

OSAMA BIN LADEN, intelligence sources would have us believe, is, among other things, a shipowner with a fleet of over 20 ships, probably flying flags of convenience (FOCs). Whether or not this is true, the world is slowly waking up to the dangers of allowing shipping to operate under the cloak offered by FOCs: no questions asked so long as the shipowner pays registration fees and tonnage taxes. Brass plates in such places as Liberia, Panama and the Bahamas, single-ship companies to limit liability and cats' cradles of ownership structures all create a wall of secrecy behind which the vessels' real owners can hide. Even Sri Lanka's Tamil Tigers are said to own a fleet.

The United States, spooked that terrorists might turn ships into floating bombs and sail them into American ports, is now demanding that shipping open up its books. Last month, at the International Maritime Organisation (IMO), a London-based agency that is part of the United Nations, the Americans presented proposals to make ownership more transparent. This triggered a chorus of protest, led by Greek shipowners who say that America only needs to know who is in day-to-day control, not the beneficial owner.

Stephen Flynn, a security adviser at the Council on Foreign Relations, who is also a former US Coast Guard commander, describes the current system as “managed anarchy”. He believes that the Americans will “engage at a higher level” if they fail to get their proposals through the IMO. An alternative route might be the OECD, which last year produced a report urging governments to clamp down on the use of brass-plate firms for illicit purposes.

All this is rather ironic. It was America, after all, that helped Liberia to create its “open” register as an alternative to Panama, the first FOC, in the late 1940s. American oil companies, with Greek shipowners riding piggyback, switched their tanker fleets to Liberia to avoid high labour costs at home (American-registered ships are required by law to use expensive American crews). Liberia's success spawned many imitators: “free flags” are now flown by such unlikely places as Cambodia and landlocked Bolivia. China is a big user of FOCs, its main preference being Panama, the world's biggest FOC by tonnage.

Panama is also among the most delinquent of FOCs. For instance, it blatantly disregards an international law requiring reports of casualty investigations to be filed with the IMO. The agency cannot force its members to apply the laws they have passed. The best it has come up with is a toothless system of self-audits.

There is a further irony: the IMO's limited powers are the result of American meddling with its

constitution in the 1950s, which gave voting powers to countries by registered tonnage rather than by goods actually traded. Liberia (America's proxy) and Panama won seats at the top table, but also became liable for a greater share of the IMO's budget. Late payments by the two have bedevilled the agency ever since.

Another try

The Americans are not the first to want FOCs hauled down. Opposition in the 1970s from transport unions and poor countries led to a proposal for a UN convention on the registration of ships, which would have imposed such strict conditions that FOCs would no longer be viable. The convention was shelved, however, when OECD countries, supported by most shipowners, ganged up on it.

So imagine the dismay of FOC-wavers on hearing that John Breaux, a Democratic senator from Louisiana, had recently proposed a bill to revive the convention as a counter-terrorism measure. Clay Maitland, senior managing partner of International Registries Inc, the company that administers the Marshall Islands flag, says that the convention is “so messed up it would take years to fix. It's the last thing I would do if I wanted speedy action.” Another option would be to strengthen the UN Convention on the Law of the Sea, which also covers ship registration and calls for a “genuine link” between ship and flag. Mr Maitland thinks this could be done more quickly.

There is yet another option—extreme, but sure to work. If the Americans were serious about destroying the monster they helped to create in FOCs, they could ban brass-plate ships from their ports. Such a move would force most FOCs to shut up shop, and the Liberias of the world to seek new sources of income.

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Petrobras

The price of freedom

May 16th 2002 | SAO PAULO
From The Economist print edition

Was Brazil wrong to set free its state oil giant?

ONLY four months after completing the liberalisation of its oil market, Brazil is having second thoughts. Was it right to give Petrobras, the state-controlled giant, freedom to set its prices, although it retains a near-monopoly in some market sectors? With rising fuel prices threatening his election chances, even Jose Serra, the candidate chosen by President Fernando Henrique Cardoso to run as his successor in October's vote, has said that the government got it wrong. Mr Serra's advisers propose either to restore price controls or to force Petrobras to sell assets. The pressure to rein in Petrobras's price freedom increased when the latest inflation figures were announced on May 10th: in April, the annual rate rose to 8%, well above the government's year-end target of 3.5%. The main cause was rising fuel costs.

Brazil started opening its market in 1999 by inviting foreign firms to drill for oil. It completed the process in January by abolishing price controls and removing Petrobras's monopoly on importing oil products. Although there are now 37 other firms exploring for oil on Brazilian territory (many in partnership with Petrobras), it will be several years before any starts producing. And, although Petrobras's petrol stations have plenty of competitors, the firm retains almost complete control of refineries, pipelines and terminals.

It would seem sensible to make Petrobras sell some of these assets. But some analysts are sceptical. A world surplus of refinery capacity means that nobody would want to buy except at knock-down prices, says Edmo Chagas of UBS Warburg. So the main result might be to destroy value at Petrobras. Since the government itself owns around a third of the company (and just over half of the voting shares), it would be harming its own interests.

Rogerio Manso, a director of Petrobras, argues that fuel retailers' newly granted freedom to import means that his firm now faces competition from foreign refineries. That there has been no rush to import shows, he says, that Petrobras's prices are not abusive. In response to bottled-gas distributors' accusations of price-gouging, Petrobras has said that it would help them to switch to buying from abroad, if they wanted to do so.

However, Marc McCarthy, an analyst at Bear Stearns, thinks that the government is likely to make Petrobras sell some assets—and he reckons that foreign oil majors might eventually buy them. In the coming years, Brazil is expected to increase both consumption and production of oil strongly. It already produces about 80% of its consumption and aims for self-sufficiency by 2005. So besides buying old refineries, the oil majors may also be persuaded to build new ones, especially once the wells they are currently drilling in Brazil start pumping. One sure way to discourage them would be to reintroduce price controls.

Given the difficulty of reconciling the short-term pressure to keep prices down with the long-term need for investment, Sebastiao do Rego Barros, head of the National Petroleum Agency and Brazil's oil-industry regulator, is refreshingly frank in admitting that he is not yet sure which way to go. It is not even clear if he, or CADE, Brazil's competition authority, has the power to make Petrobras divest assets. However, argues Mr McCarthy, the regulator does have sufficient powers to monitor Petrobras's prices, to ensure it is not abusing its strengths in refining and transport, until new competitors emerge.

It is unfortunate for Petrobras, and for the government, that the freeing of the oil market has coincided with both the election campaign (Mr Cardoso wanted to liberalise sooner, but Congress dragged its feet) and a spike in world oil prices. If prices now fall, or at least stop rising, the government and the regulator may be able to maintain the liberalisation and thus attract new investors. But if world prices rise further, forcing Petrobras to follow, the political pressure for a return to price controls may become unstoppable.

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Games on mobile phones

Fun on the run

May 16th 2002
From The Economist print edition

Hangman on your handset? It's becoming big business

IT IS an odd way to date. First, choose your lover from a list: do you fancy a barmaid, a mountaineer, a DJ or simply someone posh? When your companion opts for sparkling water on the first date, do you jokingly ask “Are u an alcoholic?” or say “Great, u can drive”? Say the right thing and you gain a point for tact. Earn 750 points and you can move in together.

It sounds artificial, and so it is. All questions and answers are transmitted by text message between mobile-phone users and a remote server that concocts imaginary dates. It may seem daft to use your mobile phone to send text messages—at about ten pence (15 cents) apiece—to an imaginary lover. But simple text-based games are catching on. Virtual Boyfriend/Girlfriend, a game created by Digital Bridges, a Scottish firm, logs some 16,500 text messages daily. Mobile-phone users have also taken a shine to such games as Wireless Pets (about the trials of pet ownership), as well as such tried-and-tested time-killers as Hangman and Blackjack.

Analysts estimate that the mobile-games industry, already booming in Japan, could be worth $17.5 billion worldwide by 2006. The simplicity of the games can mean tidy margins—though content-providers such as Digital Bridges must wrestle with mobile operators over who gets what share of the text-message fee. No wonder media giants are taking an interest. This week Bertelsmann, AOL Time Warner and Motorola bought stakes in Codeonline, a Finnish firm that provides mobile games, including spin-offs of Trivial Pursuit and “Who Wants to be a Millionaire?”, to 250m users via some 40 mobile operators. Codeonline generated more than 50m paid gaming transactions in 2001.

Games are not the only tasty bit of the mobile-entertainment field, which also includes ringtones, icons, logos and celebrity voicemail (such as “Don't terminate your call. Leave a message,” spoken by an Arnold Schwarzenegger soundalike). The personalised-ringtone market alone is expected to be worth more than $1 billion by 2004.

If growth has been steady but low-key to date, the industry is drooling over the lift it could get from the World Cup in June. Shoot-out and football-management games, plus a torrent of patriotic ringtones and logos, are already on offer. If the idea catches on, mobile-gaming firms could be among the competition's biggest winners.

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Face value

The great Swiss hope

May 16th 2002
From The Economist print edition

Can Josef Ackermann give Deutsche Bank the punch it lacks?

DEUTSCHE by name, but no longer by nature? Deutsche Bank is still, as it was a decade ago, Germany's biggest bank, adviser to—and shareholder in—some of the country's largest companies. Yet it is now a global investment bank too, with pretensions to join the best. It employs more people, and makes far more money, in London and in New York than in its home city, Frankfurt.

Josef Ackermann, who takes over on May 23rd from Rolf Breuer as "spokesman" of Deutsche's managing board (in effect, its chief executive) shuttles between homes in all three cities, plus Zurich, where his daughter is still at school. For the new boss is not even German, but Swiss. Deutsche has changed enough to prompt frequent rumours, always denied, that Mr Ackermann would like to move its headquarters to London.

As leader of Deutsche's investment bankers, Mr Ackermann has had a lot to do with the bank's metamorphosis, although he joined only in 1996 after finding himself thwarted at Credit Suisse, where he was chief executive, by an interventionist chairman, Rainer Gut. Deutsche has built a good reputation in securities trading. Two years ago Mr Ackermann's investment bankers sank Mr Breuer's plan to merge with Dresdner Bank, a Frankfurt neighbour. Mr Breuer describes the failure as the biggest disappointment of his time at the top. But Mr Ackermann, never a great fan of the deal, will have lost no sleep over its collapse.

Mr Ackermann wants to establish Deutsche as a top-five investment bank, for which it needs more oomph in the United States, despite its successful takeover in 1999 of Bankers Trust. The real work, however, is needed in Deutsche's other divisions, private clients and asset management. Margins on retail banking in Germany are thin; private banking has been a dead loss. The bank is strikingly inefficient. Last year its cost-income ratio was an appalling 90% or so.

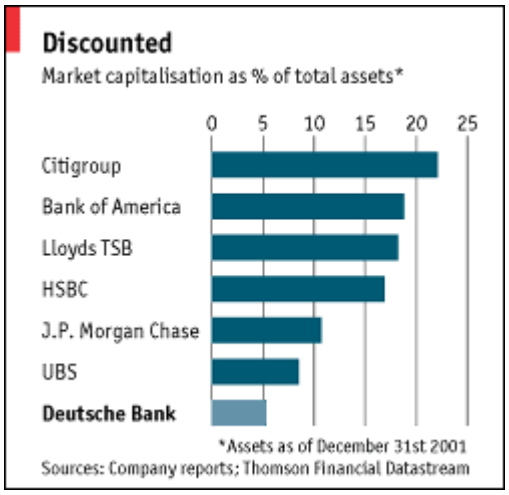
As a result, Deutsche is a heavyweight with a bantamweight's punch. In 1993 it was the biggest bank, measured by stockmarket value, outside Japan. Now, it is not even in the top 20. In one interview after another over the past fortnight, Mr Breuer has been lamenting the bank's share price. Don't worry, he says, Deutsche is an unlikely takeover target, even for the gargantuan Citigroup. However, a further round of consolidation is likely in the banking industry, and Mr Ackermann wants Deutsche to be fit for the fight.

While Mr Breuer has barely been out of the newspapers, Mr Ackermann has said little since being made heir-apparent. This is partly a matter of form: Mr Breuer is still in office. But it is also a matter of style. With his permanent tan and beaming smile, Mr Breuer has always enjoyed the limelight. This has led to some embarrassments—not only the Dresdner fiasco, but also some invidious remarks about the creditworthiness of Leo Kirch, a customer. Mr Ackermann also smiles a lot, but he is more self-effacing (he has been dubbed "Low-key Joe"). He is less likely than his predecessor to rush into headline-grabbing mergers.

On the importance of pushing up the share price, however, the two men are of one mind. With cheap shares, Deutsche can buy little that is worth having. Forget for now even a weakened Merrill Lynch, let alone Morgan Stanley, to secure Deutsche's spot in the "bulge bracket" of top investment banks. Forget, on the retail side, such prizes as Lloyds TSB, with which Deutsche discussed a merger last year. Although Deutsche's balance sheet is two-and-a-half times the size of Lloyds TSB's, the British bank is worth 40%

more on the stockmarket.

Deutsche's new fitness regime has already begun. The management board has been slimmed, and since January the bank has been run day-to-day by an executive committee, chaired from next week by Mr Ackermann. Not everybody liked this centralising of power: the new order prompted the departure of the chief risk officer, Thomas Fischer, who once fancied himself for the top job.



Mr Ackermann has shown himself a proficient cost-cutter in the past, at the expense of American investment bankers. Deutsche will surely now make more than the 9,200 job cuts already announced. It is also sorting out just which businesses it should be in at all. Passive asset management, where margins are thin and Deutsche lacks scale, may be sold; Mr Breuer has already bought two active asset managers, which promise richer pickings. Mr Ackermann is likely to take the retail-banking arm, Deutsche Bank 24, out of France, where it has achieved little, but keep it in Spain and Italy, where it has done well. Small firms, which want little more than basic loans, will be steered away from the corporate bank to Deutsche Bank 24. Deutsche will not complain if they leave altogether.

Mr Ackermann will also sell Deutsche's *euro*14 billion ($12.6 billion) of industrial shareholdings. This was planned anyway, but he will now speed it up. Because the holdings are mainly small stakes in firms whose shares are heavily traded, most could go within a year. More awkward packages, including one-eighth of DaimlerChrysler, may take longer.

If all this freed capital is put to better use, Mr Ackermann ought to succeed in pushing the share price up. But that is a big if. He has given no sign that he intends Deutsche to be anything other than a giant universal bank—even though it is not clear that retail banking in Germany can ever earn a decent return. One day it may be better to get out altogether.

For now, there is much to be said for sticking to the chosen course. In the past few years, analysts have lost count of the number of Deutsche reshuffles and new strategies. Given the bank's recent past, a lot of hope is riding on Mr Ackermann's ability to raise the share price—preferably without resorting to yet another wrenching overhaul. Being less hasty and less flashy than Mr Breuer may prove to be the new man's strongest asset.

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Rating agencies

Badly overrated

May 16th 2002
From The Economist print edition

Regulators and investors rely too heavily on credit ratings

PITY the poor rating agencies. They work their socks off trying to give sensible credit ratings to every financial instrument they are asked to assess. Now they are under attack: from countries that claim to have been unfairly downgraded (such as Japan, see article); from companies struggling to cope with adverse markets; and from investors alarmed at the speed with which triple-A names can sink to single-B. America's regulators are also, post-Enron, reviewing the top three agencies' quasi-official status, for anti-competitiveness and potential conflicts of interest.

Never, it seems, has so much been demanded of rating agencies—or expected of them. This week, Standard & Poor's created a stir when it announced a new definition of "core earnings" that would include items such as the estimated cost of stock options that companies prefer to leave out. The agencies' traditional work of rating debt securities has been further stretched to cover exotic structured-finance instruments devised by investment banks. Analysts at the top three agencies (S&P, Moody's Investors Service, and their smaller rival, Fitch) are hamstrung by their limited range of weaponry—the letters AAA to D (default)—and by old methodology that cannot adapt to the dynamics of the newest financial instruments.

Take today's craze for collateralised debt obligations (CDOs). CDOs are a way of taking a bundle of credit risks and slicing them into layers that carry different levels of risk. Sophisticated investors may be able to assess these risks themselves. But most are guided by the ratings assigned to each slice by the agencies. (The lowest slice is usually left unrated.)

A rating too far

These portfolios soon take on a life of their own, as the agencies have discovered. Many are actively managed: some debt matures or defaults and must be replaced; collateral deteriorates and must be topped up. Rating agencies recognise that the value of a managed CDO depends as much on the quality and behaviour of the asset manager as it does on the underlying credits. So they are being forced to become raters of asset managers, as much as cold assessors of the underlying assets.

This is just one example of how ratings have moved beyond the concept of a simple benchmark. What makes matters worse is that the use of ratings as absolute measures, by investors and by regulators, is increasing not decreasing.

For 30 years, the Securities and Exchange Commission (SEC) has used ratings by "nationally recognised" agencies to assess the value of securities held by securities firms, and the amount of capital they must hold. Many investment institutions must by charter put most or all of their money into instruments that are investment-grade—between AAA and BBB-. Many loan agreements and issues of debt securities now include ratings triggers: if there is a downgrade, the interest rate is increased, or sometimes the debt must be repaid immediately. The consequences of a simple downgrade can thus be devastating for a company. Downgrades of major companies or countries to below investment-grade also tend to trigger a sell-off by investors whose charter stops them from holding such assets.

Credit ratings are about to acquire even wider influence. Under the new Basel

proposals for banks' capital requirements, to be applied by 2006, ratings may be used to assess the riskiness of a bank's entire portfolio. Banks are being encouraged to use their own internal rating systems, but the benchmark will tend to be that of officially recognised rating agencies. The scope for playing games, and cherry-picking the most favourable ratings, will increase, and may even come to dominate banks' risk-management decisions.

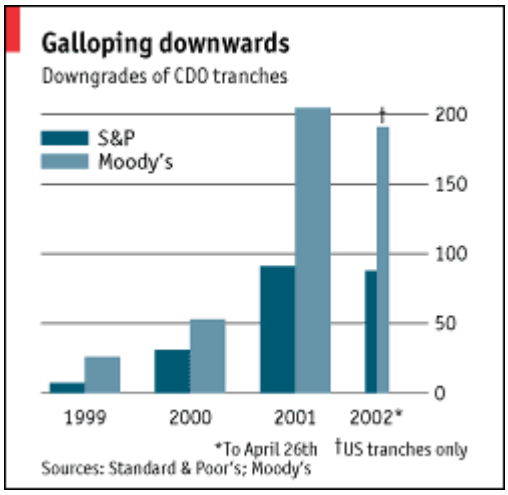
The use of ratings as absolute measures, by investors and by regulators, is increasing not decreasing

The shellgame played around CDOs should be enough to alert investors and regulators to a looming danger. To construct CDOs, investment banks work intensively with rating agencies to achieve investment-grade ratings for the top tranches, without which they cannot be sold to a wide range of investors. CDOs are created from existing debt: no new debt is involved. So the market has already bought this stuff once before. Why are millions of dollars being made in fees and dealing spreads by simple repackaging?

One answer is that new players, such as insurance companies, are joining the game. But an even simpler answer is that it is a game of rating arbitrage. If the ratings did not carry such weight with regulators, and in fund-management mandates, neither would the shifting of assets from one rating grade to another. “How can you repackage and apparently add such value?” asks Con Keating of the Finance Development Centre in London. “The arbitrage does not go away.”

Accelerating downgrades are beginning to dent the CDO ratings' credibility (see chart). All three agencies put huge resources, legal and technical, into an independent analysis of these structures. But they are under pressure from issuers and banks to deliver a high rating for as much of the pool as possible. Is there a conflict of interest? Potentially, yes: the bankers, or their issuing clients, pay the rating agencies, yet the agencies are supposed to represent the interests of investors.

Rating agencies respond that they would do nothing to jeopardise their greatest asset, which is their reputation. Indeed, the agencies, argues Steven Schwarcz, a professor at Duke University, Illinois, are more likely to have a conservative bias than an innovative one, because of reputation risk. Yet reputation risk did not stop Andersen's audit failings at Enron.



How accurate are ratings, anyway? Some analysis suggests that bond ratings, at least, have a good record. But plenty of sovereign and corporate creditors, having seen their assets caught by untimely downgrades, disagree. There is some evidence of a growing divergence between credit spreads and credit ratings. Yet the three rating agencies are so entrenched that they are part of the market fabric.

At a Senate hearing on rating agencies in Washington on March 20th, Mr Schwarcz pointed to the difficulty of getting anybody else, besides the issuer of securities, to pay rating agencies. Payment by regulators would be expensive; payment by investors would mean identifying them before the securities are sold. The SEC has other regulatory concerns. Recognised rating agencies have responsibilities under the Investment Advisers Act of 1940, but there is no regulation governing the quality or reliability of their ratings. That there are only three recognised rating agencies in America, and thus in effect in the global capital markets, may make them less aggressive at “ferreting out the truth”, worries Mr Schwarcz.

For a mere three rating agencies to guard their reputation “all they need is relative strength,” says Mr Keating. He cites the examples of Enron and South Korea, when the ratings of all three agencies badly lagged events. “That doesn't help us against systemic risk.”

Regulating the rating agencies would be expensive and not necessarily an improvement. Better might be the opposite: reducing the reliance on ratings for regulatory purposes. That would encourage new entrants and new methodologies to address the shortcomings of the big three. Competitors that have sprung up in the past have too often been gobbled: KMV, a Californian rating firm, was acquired recently by Moody's. Investors should also learn, not least from the CDO experience, that ratings, like investment-bank research, can never be a substitute for independent analysis and due diligence.

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Japan's credit rating

A1 for risk, D for effort

May 16th 2002 | TOKYO
From The Economist print edition

How do you rate a government that wallows in a class of its own?

AP

An odious comparison, says Koizumi

ONE notch or two? That was the question hanging over Tokyo's markets this week, as investors waited for Moody's Investors Service to deliver another blow to Japan's sovereign credit rating. The agency had already served notice that it is mulling over another downgrade, perhaps lowering Japan by two pegs in one go. Yet instead of doing it early in the week, as expected, Moody's announced on May 14th that it will decide by the end of this month. Some onlookers concluded that only a one-notch downgrade is pending. But even that would give little solace to indignant Japanese officials, who continue to lambast the rating agencies' methods.

Japan's local-currency sovereign debt (at Aa3 on the Moody's scale) is already languishing three grades below “triple-A”. Another notch downward would put it on a par with Chile, Estonia, Hungary and Botswana. That last comparison seems especially to annoy Junichiro Koizumi, Japan's prime minister, who railed recently at being rated in the neighbourhood of “African countries to which Japan is providing assistance”. Officials from the Ministry of Finance have chimed in as well, accusing Moody's and the other big agencies—Standard & Poor's and Fitch—of making unfair qualitative judgments and focusing too little on comparable figures.

The agencies point out that, even at four or five notches below top grade, their ratings still imply a very low risk of default. But this argument does not appease the Japanese, any more than other debt issuers who wonder why the agencies need so many gradations if there is barely any difference in default risks.

In taking on the rating agencies, Japan's officials make two main arguments. Masaki Omura, the Finance Ministry's point man in the discussions, claims that the agencies place too much emphasis on trends within a country, and not enough on consistency across countries. So if credit raters believe (misguidedly, you understand) that Japan's reform efforts are growing ever more pitiful, they will continue to knock its ratings down another peg from time to time. The trouble, says Mr Omura, is that this may take Japan far out of alignment with other countries where the reform outlook does not change much.

On this point, Japan's government is on weak ground. The rating agencies never tire of listing hard numbers to describe Japan's economic plight. Its annual budget deficits run at 8% of GDP, its public debt will reach 157% of GDP this fiscal year, and a steady stream of deflation numbers suggests that the rot will become ever less manageable. If we repeated the figures on Japan's rapidly ageing population (which adds hugely to the future financial burden) the reader might start yearning for an afternoon nap.

In truth, many of the countries that Japan's government looks down on boast far sounder economic fundamentals in many areas. They also lack some of Japan's advantages, such as its wealth, technology and high savings rate. But when countries are compared, the relative risks depend on what weights are assigned to different factors. Since Japan's economy is so unlike those of smaller countries with sounder finances, such comparisons become harder to make. But that does not mean that Japanese public finances are sustainable.

The Finance Ministry's other complaint has more force, however. Unlike corporate-debt ratings, or sovereign ratings for foreign-currency debt, the entire rationale for local-currency sovereign ratings seems a bit moot. The point of credit ratings is, after all, to gauge the risk of non-payment. Yet when

governments rack up huge debts in their own currency, inflation, not default, is the real risk to creditors. That is especially true in a country like Japan, in which domestic investors hold 95% of government bonds. “Although we have no intention to monetise, it is the right of a sovereign issuer to make currency,” says Mr Omura. “So it is almost unthinkable that we would default.”

The rating agencies do usually consider inflation when gauging default risk, since hyperinflation carries a risk of devaluation, political instability and other nasty effects. But such a back-door approach seems too fuzzy to justify fine distinctions between countries.

Such arguments offer little solace to the Japanese citizens who actually hold so many of their government's bonds. Besides the risk that the government will one day inflate away the value of their holdings, they must also expect it to raise their taxes and/or slash their health and pension benefits. Like inflation, a broken social-security promise does not count as default; but if you are on the receiving end, it hurts just as much.

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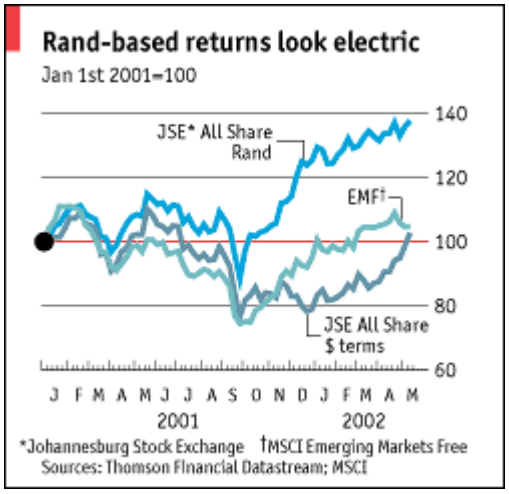
The Johannesburg stock exchange

Turn on the lights

May 16th 2002 | JOHANNESBURG
From The Economist print edition

An upgrade for Africa's biggest trading floor



SHACKS beside mineheads, gaggles of paper-waving miners and a few rough-and-ready investors gave birth to Johannesburg's first stock exchange 115 years ago, in the gold rush that created the city. At a ceremony on May 17th, South Africa's president, Thabo Mbeki, was due to throw the switch on something more high-tech: a 60m rand ($6m) electronic trading system, adopted from London. Taking the London Stock Exchange's SETS system will give the Johannesburg Stock Exchange (JSE) a higher profile internationally, says both the exchange and local traders. Will it boost Africa's largest and most important trading floor?

Not that the JSE needs much help. It is doing pretty well anyway, with an average of 15,000 daily trades and a market capitalisation of traded companies of 1.9 trillion rand. For the past few months the local index has roared. The rand's slump late last year helped exporters, and gave a shine to oil and mining companies, which sell in dollars but have costs in rand. More recently a surging gold price has kept things rosy, despite the rand's recovery. The JSE has risen by 10% since the start of the year, measured in rand; in dollar terms by roughly 30%. That makes it one of the best performers in the world.

Trading in stocks should now be quicker and easier, making the market more liquid, and so more attractive to investors. And a new index of South African stocks based on their free-float—the number of shares freely available for investors to trade—will be launched on June 24th.

All this is welcome, after a few years of gloom. Crime forced the exchange to move from central Johannesburg to Sandton, a business suburb. And despite great efforts to bring in black-owned companies, the JSE remains almost exclusively white. Worse, some of the country's biggest companies, such as South African Breweries and Anglo American, a mining conglomerate, have moved their primary listings to London in search of more capital. That is not all bad, since the giants had long dwarfed the rest of the JSE; but medium-sized companies may want to follow. They might stay if exchange controls for local businesses are lifted, and if the fancy new trading system works well. The JSE has come a long way from its shacks and mineheads.

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Insurance

One attack or two?

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A World Trade Centre insurance payout depends on legal niceties

AP

Stand-off at Ground Zero

WHO will rebuild lower Manhattan and how quickly could hang on a single word: “occurrence”. This is a technical insurance term. At issue is whether the two aeroplanes crashing into the World Trade Centre's twin towers represented one occurrence, insured for $3.5 billion, or two, insured for double that amount.

A ruling on occurrence will probably settle a lawsuit brought by a consortium of insurers led by Swiss Re against the leaseholders of the WTC towers, headed by Larry Silverstein, a New York property developer. If a federal court in Manhattan decides that the collapse of the towers was a single terrorist attack, as the insurers claim, the payout will be $3.5 billion. If it decides there were two events, as claimed by Mr Silverstein, the proceeds will be doubled, giving him enough cash to redevelop the WTC complex.

Legal disputes over occurrence are not unusual. Some property-and-casualty policies either ignore occurrence, or define it only in vague terms. By coincidence, a judge in California ruled on September 11th that four fires set by the same arsonist within a couple of hours in four different county courthouses constituted four separate occurrences. Insurers had argued that the fires were one event.

Even so, the WTC case is of unprecedented size and complexity. The WTC cover was the biggest insurance policy ever on a single real-estate complex. As the Silverstein consortium had only recently signed its lease from the Port Authority of New York & New Jersey, the policy was a so-called binder agreement—a preliminary arrangement, to be finalised within a few months. The wording is less detailed than a final policy document, leaving more room for disagreement.

This week the court was to hear the arguments. Swiss Re, representing 22 insurers in the consortium (so far only Ace and XL, two Bermuda-based insurers, have settled with Mr Silverstein), claims that the consortium agreed to cover the WTC under WilProp 2000, a policy form put together by Willis, an insurance broker. It defines occurrence as a loss “attributable directly or indirectly to one cause or series of similar causes.” This seems to support the one-occurrence thesis.

Mr Silverstein and his New York lawyers at Wachtell, Lipton, Rosen & Katz argue that WilProp is superseded by a form prepared by Travelers Indemnity, one of the primary insurers in the consortium. Travelers was willing to underwrite the WTC policy only if its own insurance form was used. The Travelers document does not define occurrence, which seems to strengthen the two-occurrence claim. Mr Silverstein's lawyers claim that Swiss Re was informed of Travelers' demands. From the end of July 2001, they say, insurers and policyholders were negotiating the wording of the WTC cover under Travelers' terms and conditions. The final document was still not agreed when the attacks happened, but there was a binder in place. Under New York law, binders are fully applicable.

Last week there was some nasty legal wrangling. Swiss Re alleged that Mr Silverstein's lawyers had exerted “fantastic pressure” on brokers at Willis to testify, and even to lie, to support the Silverstein case. “An outrageous lie,” says Marc Wolinsky at Wachtell.

The Silverstein camp is confident that, even if the Travelers form is judged not to apply to all members of the consortium, they have the law on their side. New York insurance legislation looks at the immediate physical cause of a loss, says Mark Geistfeld at New York University's School of Law. What caused the

collapse of each twin tower was two aircraft crashes, 17 minutes apart.

Will Mr Silverstein be able to rebuild lower Manhattan? Last week he began work on a new skyscraper on the site of 7 World Trade Centre, after a dispute with Industrial Risk Insurers (IRI) had been resolved. The twin towers dispute is unlikely to settle so swiftly. Jury trial is scheduled for September 3rd, but it might be postponed. Mr Silverstein is doubly coy about his plans for the site. His previous idea, to rebuild the twin towers, was squashed by a public outcry.

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Mortgage bonds and real estate

Just pay

May 16th 2002 | NEW YORK
From The Economist print edition

To the capital markets, no land is sacred

THERE are tough bankers, and really tough bankers. Then there is the commercial-mortgage-backed securities market, perhaps the toughest of them all. Witness the foreclosure notice received by the tenants of 110 Greenwich Street, a 13-floor apartment building that is 200 metres south of the former World Trade Centre.

Even the flintiest New York lenders are dealing gently in that area, considered by many locals as hallowed ground. When it comes to Ground Zero, nobody wants to be considered a louse—or at least nobody based in the city.

This foreclosure notice, however, was sent by the Dallas-based subsidiary of ORIX, a Japanese finance company that services an $800m mortgage-backed security, including a $14m mortgage on 110 Greenwich and more than 100 others around the country. ORIX is paid to collect loan payments and also has a position in the riskiest slice of the mortgage-backed offering, which means that it takes the first hit if any loans sour. Not surprisingly, it is a staunch defender of creditor rights.

“We have an obligation to the certificate holders,” says James Thompson, chief executive of ORIX Capital Markets. Unsurprisingly the owners of 110 Greenwich believe this is shortsighted. A decade ago, the area behind the American Stock Exchange was a particularly tired stretch of downtown Manhattan. Municipal tax breaks to convert offices into apartments prompted two brothers and an associate to buy the building for $4m in 1997 and convert it for $10m. Tenants flocked in. Two years ago the debt was refinanced and securitised by three New York banks: PaineWebber, Chase, and Salomon Smith Barney.

During the World Trade Centre attacks, the windows blew out at 110 Greenwich, and flying girders damaged the roof. Every inch of the building was covered by thick soot. Many tenants worked in or near the centre. Although none was hurt, some had narrow escapes, including the building's superintendent, who went into premature labour while desperately hunting for a child who had been in day care.

For two months after the attack, soldiers blocked access. Utility companies cut deep trenches for vital new connections. Several nearby buildings were abandoned. Undeterred, the owners of 110 spent $400,000 cleaning it, with $170,000 coming from insurance, and $230,000 from reserves and new investment.

Only 20% of the tenants returned in December—a particularly low number, because of the embattled location—paying at least 20% less. The biggest tenant, a street-level health club, couldn't pay at all but was allowed to stay—partly because it livened up the neighbourhood, partly because nobody was rushing to fill the space.

At least two reorganisation plans were submitted to ORIX, the first in February when conditions were especially dire, the second in April when things were somewhat better. Both plans sought to postpone debt payments, and to reduce them to cover interest only. ORIX refused to negotiate. Meanwhile, re-letting continues apace, bringing life to a damaged street. Almost all the units at 110 Greenwich are now let, albeit at lower rates. But two days after the new rent roll was submitted in late April, ORIX filed for foreclosure. “The owners are contractually obligated to pay, and they are capable of paying,” says Mr Thompson.

Conceivably, the property could revert to the creditors. If the reconstruction of lower Manhattan continues its positive course, the result could even be an investment coup. Not long ago, everybody on Wall Street believed financial markets should always work this ruthlessly.

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European jobs

Starting to work

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From The Economist print edition

Despite headlines about strikes, Europe's job market looks more flexible

GERMANY has just seen its most serious industrial dispute for seven years. After holding a series of one-day strikes, IG Metall, its giant engineering union, won a 4% pay rise for this year. Last month, Italians staged a general strike, the country's most disruptive stoppage for 20 years, to protest over reforms to make it easier to fire workers. Next month there is the prospect of a general strike in Spain to oppose cuts in jobless benefits. It might seem that nothing has changed: Europe's trade unions are as bolshy as ever, and its labour markets just as sclerotic. Delve deeper, however, and there are real signs of hope.

First, the hefty pay rises being won in Germany and some other European economies follow years of restraint, which had reduced workers' share of GDP even as profits boomed. Lombard Street Research estimates that, in both Germany and the euro area as a whole, real pay has risen on average by 0.7% a year less than productivity growth over the past decade. It is not surprising that workers are trying to make up some lost ground.

But it is surprising that pay rises in Europe have recently been so low, even though average unemployment in the euro area fell from almost 12% in 1997 to 8.4% last year. Michael Dicks, an economist at Lehman Brothers, suggests that the structural unemployment rate (the rate consistent with stable wage inflation) may have fallen, thanks to a rise in the number of workers on temporary and part-time contracts. This makes it easier for firms to hire and fire. The share of part-time or temporary workers has increased from 21% to almost 30% in the past decade.

A further sign that labour markets are working more flexibly is that growth has become more job-intensive. During last year's downturn, employment rose by an average of 1.3% in the euro area, while unemployment remained broadly unchanged. The jobless rate rose slightly in Germany, but fell in the rest of the euro area. In the past, a similar slowdown in growth would have pushed up unemployment right across Europe.

In America, where growth slowed more sharply last year, unemployment has jumped from 3.9% in late 2000 to 6% last month. As a result, the gap between the jobless rates in America and Europe has narrowed considerably (see chart). In the European Union as a whole, unemployment has fallen to 7.6%.

This is not just a one-year wonder. Employment has risen faster in the euro area than in the United States in each of the past four years. European firms today have more incentive to hire new workers than they did, thanks to the loosening of rules on hiring part-time and temporary workers, and a reduction in employers' social-security taxes in some countries. It is true that the resilience of employment partly reflects a fall in average weekly hours worked. But even taking this into account, total hours worked in the euro area have been rising by more than 1% a year for the past five years. In the first half of the 1990s, total hours worked fell by an annual average of 1%.

The downside of more labour-intensive growth is that Europe's productivity growth has slowed. Many of the new jobs created have been for lower-paid, lower-skilled workers, which reduces labour productivity—just as in America in the 1980s and early 1990s. In the long term, however, a livelier jobs market should improve Europe's growth prospects.

In any case, the most popularly quoted productivity numbers exaggerate the gap between America and Europe. According to figures published by the European Central Bank, productivity in the euro area saw no growth at all in 2001. In America, official figures put its productivity growth at 1.9% last year. However, the two numbers are not comparable. America's productivity is measured in output per hour; Europe's is measured in output per employee. CSFB, an investment bank, estimates that GDP per hour worked rose by about 1% in the euro area last year, narrowing the gap with the United States.

A more serious distortion is that GDP, on which productivity figures are based, does not allow for capital depreciation. A better measure of economic progress is net domestic product (NDP), which subtracts depreciation. Normally GDP and NDP grow at roughly the same speed, but in recent years a big gap has opened up in America, as the average rate of depreciation has soared following big increases in investment in computers and software, which have a shorter asset life than traditional machinery. This makes a huge difference: in 2001 GDP in America rose by 1.2%, but NDP fell by 0.1%.

CSFB calculates that NDP per hour worked rose by only 0.8% in America last year, no faster than in the euro area. Over the five years to 2001, real NDP per hour rose at the same average annual pace of 1.5% in both America and Europe. Indeed, on this measure America's productivity growth rose only modestly between the first and second halves of the 1990s. The conventional wisdom that Europe lags the United States in job creation and productivity growth may need to be revised.

None of this is to deny that Europe could do better. The big three euro economies, Germany, France and Italy, still have some of the most heavily regulated labour markets in the developed world. If they pushed ahead with structural reforms, unemployment could be much lower. Mr Dicks at Lehman has developed an economic model of how various structural labour-market policies affect unemployment. He estimates that if job protection, jobless benefits and marginal tax rates were reduced to the level of the least regulated developed countries, unemployment in the euro area could be cut almost in half, to 4.5%. Why wait?

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Tax wars

UnAmerican

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The American taxman creates a storm

A DISCREET change of address, from gritty New Britain, Connecticut to the posher environs of Bermuda and Barbados: that is all Stanley Works, a well-known American tool maker, hoped for when it tried earlier this month to move its legal domicile to a milder tax climate. Now, after one botched shareholder vote on the question, the company will try again, even though it plans only a token presence in the islands. Congressmen have kicked up a fuss, calling the company “unpatriotic”. Yet the bigger problem may be the rift between America's free-trade rhetoric and its tax laws.

America's taxmen put on imperial airs. They tax American companies—and citizens—on their worldwide income: profits from Big Macs cooked in Bangkok or Cokes sold in Egypt are subject to a stringent look back home. Stanley Works wants to join other big American companies, such as Tyco International and Ingersoll-Rand, which have fled to island havens to protect their profits earned outside America. This, they say, puts them on a par with their European rivals.

But, says Michael Graetz, of Yale Law School, such foreign domiciles can also be used to avoid taxes on profits earned in America by, say, using offshore entities to re-label profits as tax-deductible interest. After Enron's clever use of Caribbean trusts, and amid a new push to cleanse foreign tax havens of terrorist money, any offshore moves these days can look dodgy.

Stranger still, what the taxman takes with one hand, he gives away with another. America is already in breach of world trade rules for its tax subsidies for domestic exporters. Congress may seize this chance for a broad review of corporate tax, to make it simpler, fairer, and compliant with trade laws. A value-added tax, a fine idea, has been mooted. But don't hold your breath. More likely is a proposal aimed merely at putting brakes on footloose firms.

Trade unions, some of Stanley's fiercest critics, claim only to want the company to pay its fair share. Yet the move offshore would create a capital-gains tax bill for shareholders—including angry employees and pensioners—of around five times as much as Stanley's expected yearly tax savings. It sounds like a chance for shareholders to show their patriotism.

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Economics focus

The growth machine

May 16th 2002
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Economists have thought too little about how innovation happens

INNOVATION is an obsession of management gurus. Books such as “The Innovator's Dilemma” and “Innovate or Die” often top the business bestseller lists. That this is not an obsession shared by economists is remarkable. The dismal science certainly acknowledges the crucial role played by innovation in driving economic growth. But the fact that innovation happens is mostly taken as a given; the how and why of innovation remain largely ignored.

Some of the most up-to-date thinking on the subject remains that of Joseph Schumpeter in the first half of the 20th century. Indeed, the late great Austrian economist was lauded as a prophet of the “new economy” that briefly bloomed during the late 1990s, largely for his description of a process of “creative destruction” in which innovative new firms drive lumbering established companies from their dominant market positions. Never mind that much of Schumpeter's work actually celebrated the role of established firms in innovation.

To put right the previous oversight, William Baumol, a veteran economist at Princeton University, has written a splendid new book, “The Free-Market Innovation Machine”*. Building on the insights of Schumpeter and even of Marx (though this is a devoutly pro-capitalist tome), he argues that it is, above all, the ability to produce a continuous stream of successful innovations that makes capitalism the best economic system yet for generating growth. This is for two main reasons. Under capitalism, “innovative activity—which in other types of economy is fortuitous and optional—becomes mandatory, a life-and-death matter for the firm.” Second, new technology is spread much faster because, under capitalism, it can pay for innovators to share their knowledge and “time is money”.

If the capitalist system can be seen as a “machine whose primary product is economic growth”, what are the machine's components? The rule of law, of course, especially the protection of property (including intellectual property) and the enforceability of contracts. This motivates innovators by ensuring that they can gain some reward for their efforts.

Some economists debate why countries such as America are more blessed with entrepreneurs than others (the former Soviet Union, say). Mr Baumol argues that there are entrepreneurs in every sort of system: what differs is whether or not they devote their energies to producing innovations that add to economic growth. And this depends on the incentives provided by the economic system. Non-capitalist systems often give entrepreneurs most of their rewards for innovations that do not contribute to growth, such as finding clever ways to win patronage from the state, creating monopolies, or crime. There is some of that in capitalist countries, but far more upside for growth-producing innovators.

From garage to lab

What of the lone entrepreneur building some world-changing invention in his garage? Such pioneers play an important role, particularly in devising radically new technologies. But a more important role in innovation is played by large established firms. They have changed innovation from an erratic “Eureka! I've found it” process into a more regular and predictable activity. Large firms with the resources to invest in “routinised” innovation and the incentive to do so are a unique feature of capitalist economies. Other economic systems have been innovative enough, but have failed to exploit their innovations—or have had big firms but no incentives to innovate.

The industrial structure that fosters productive innovation best is oligopoly, argues Mr Baumol. Oligopoly

falls between monopoly—where one firm rules—and perfect competition, in which many firms compete and no single firm sets prices. In oligopoly, a few big firms compete with each other, but not primarily by trying to charge the lowest prices, which are thus usually higher than in a perfectly competitive market. Instead, oligopolists compete by making their products differ slightly from their rivals'. Innovation is a growing source of such product differentiation, says Mr Baumol.

It is ironic that competition through innovation by oligopolists may be the main driving force of growth and higher living standards, since oligopolies are often seen as a threat to the public interest and as a target for antitrust action. Mr Baumol urges antitrust authorities to judge innovative oligopolists less harshly.

Mr Baumol also tackles two other misleading beliefs. One is that innovators jealously guard their proprietary technologies through patents, lawsuits and secrecy, to maximise for as long as possible the above-normal profits they can earn from their innovation. In the real world, innovative firms are often remarkably quick to license new technology or to become members of technology-sharing consortia. Capitalist incentives explain why, says Mr Baumol. If other firms expect to be more efficient at exploiting your innovation, and so will pay more to use it than the innovative firm could make by keeping it to itself, it makes economic sense to license it to them.

Some economists argue that a shortfall in the legal protection granted to innovators means there is not enough innovation. Mr Baumol reckons that, on average, less than 20% of the total economic benefits of innovations go to those who invest directly or indirectly in making them happen. The rest of the benefit spills over to society at large. Arguably, stronger patents and other intellectual-property rights that made it easier for innovators to keep their proprietary technology to themselves or charge more for licensing it would increase total innovation.

But would that be progress? Mr Baumol doubts it. The rapid dissemination of innovation through the economy via spill-over effects has a hugely positive impact on economic growth, he says. Better protection for innovators might increase innovation but, by slowing its spread, reduce growth. For all the benefits that flow from innovation, it seems you can have too much of a good thing.

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* “The Free-Market Innovation Machine. Analysing the Growth Miracle of Capitalism”, by William Baumol. Princeton University Press (Amazon.co.uk).

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About sponsorship

The rise of the dinosaurs

Footprints in the muds of time

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Reuters

The dinosaurs may have risen to power in as little as 10,000 years

EVERYBODY knows that the dinosaurs were killed by an asteroid. Something big hit the earth 65m years ago and, when the dust had fallen, so had the great reptiles. There is thus a nice, if ironic, symmetry in the idea that a similar impact brought about the dinosaurs' rise. That is the thesis proposed by Paul Olsen, of Columbia University, and his colleagues in this week's *Science*.

Dinosaurs first appear in the fossil record 230m years ago, during the Triassic period. But they were mostly small, and they shared the earth with lots of other sorts of reptile. It was in the subsequent Jurassic, which began 202m years ago, that they overran the planet and turned into the monsters depicted in the book and movie “Jurassic Park”. (Actually, though, the dinosaurs that appeared on screen were from the still more recent Cretaceous period.) Dr Olsen and his colleagues are not the first to suggest that the dinosaurs inherited the earth as the result of an asteroid strike. But they are the first to show that the takeover did, indeed, happen in a geological eyeblink.

A lucky strike

Dinosaur skeletons are rare. Dinosaur footprints are, however, surprisingly abundant. And the sizes of the prints are as good an indication of the sizes of the beasts as are the skeletons themselves. Dr Olsen and his colleagues therefore concentrated on prints, not bones.

The prints in question were made in eastern North America, a part of the world then full of rift valleys similar to those in East Africa today. Like the modern African rift valleys, the Triassic/Jurassic American ones contained lakes, and these lakes grew and shrank at regular intervals because of climatic changes caused by periodic shifts in the earth's orbit. (A similar phenomenon is responsible for modern ice ages.) That regularity, combined with reversals in the earth's magnetic field, which are detectable in the tiny fields of certain magnetic minerals, means that rocks from this place and period can be dated to within a few thousand years. As a bonus, squishy lake-edge sediments are just the things for recording the tracks of passing animals. By dividing the labour between themselves, the ten authors of the paper were able to study such tracks at 80 sites.

The researchers looked at 18 so-called ichnotaxa. These are recognisable types of footprint that cannot be matched precisely with the species of animal that left them. But they can be matched with a general

sort of animal, and thus act as an indicator of the fate of that group, even when there are no bones to tell the story.

Five of the ichnotaxa disappear before the end of the Triassic, and four march confidently across the boundary into the Jurassic. Six, however, vanish at the boundary, or only just splutter across it; and three appear from nowhere, almost as soon as the Jurassic begins.

That boundary itself is suggestive. The first geological indication of the impact that killed the dinosaurs was an unusually high level of iridium in rocks at the end of the Cretaceous, when the beasts disappear from the fossil record. Iridium is normally rare at the earth's surface, but it is more abundant in meteorites. When people began to believe the impact theory, they started looking for other Cretaceous-end anomalies. One that turned up was a surprising abundance of fern spores in rocks just above the boundary layer—a phenomenon known as a “fern spike”.

That matched the theory nicely. Many modern ferns are opportunists. They cannot compete against plants with leaves, but if a piece of land is cleared by, say, a volcanic eruption, they are often the first things to set up shop there. An asteroid strike would have scoured much of the earth of its vegetable cover, and provided a paradise for ferns. A fern spike in the rocks is thus a good indication that something terrible has happened.

Both an iridium anomaly and a fern spike appear in rocks at the end of the Triassic, too. That accounts for the disappearing ichnotaxa: the creatures that made them did not survive the holocaust. The surprise is how rapidly the new ichnotaxa appear. *Eubrontes giganteus*, for example, is there a mere 10,000 years after the iridium anomaly. The *Eubrontes* prints were made by theropods—the dinosaur group that went on to produce such nightmares as *Allosaurus* and *Tyrannosaurus*—and *Eubrontes* is already 20% bigger than any theropod track recorded from the Triassic.

Dr Olsen and his colleagues suggest that the explanation for this rapid increase in size may be a phenomenon called ecological release. This is seen today when reptiles (which, in modern times, tend to be small creatures) reach islands where they face no competitors. The most spectacular example is on the Indonesian island of Komodo, where local lizards have grown so large that they are often referred to as dragons. The dinosaurs, in other words, could flourish only when the competition had been knocked out.

That leaves the question of where the impact happened. No large hole in the earth's crust seems to be 202m years old. It may, of course, have been overlooked. Old craters are eroded and buried, and not always easy to find. Alternatively, it may have vanished. Although continental crust is more or less permanent, the ocean floor is constantly recycled by the tectonic processes that bring about continental drift. There is no ocean floor left that is more than 200m years old, so a crater that formed in the ocean would have been swallowed up by now.

There is a third possibility, however. This is that the crater is known, but has been misdated. The Manicouagan “structure”, a crater in Quebec, is thought to be 214m years old. It is huge—some 100km across—and seems to be the largest of between three and five craters that formed within a few hours of each other as the lumps of a disintegrated comet hit the earth one by one. Such an impact would surely have had a perceptible effect on the world, but the rocks from 214m years ago do not record one. It is possible, therefore, that Manicouagan has been misdated. That will be the next thing to check.

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Radiology

X-ray specs

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A new technique could turn medical X-rays into precision instruments

TWO things of note happen to X-rays when they are aimed at something which is not completely opaque: they are absorbed, and they are refracted. Traditional radiology uses absorption to create the familiar blurred grey-and-white images of X-ray photographs. Refraction, however, has not been much exploited medically—or, at least, not until now.

Giorgio Margaritondo, of the Ecole Polytechnique Fédérale de Lausanne, in Switzerland, hopes to change that. He and his colleagues have developed a new body-imaging technique that is based on X-ray refraction. They believe it is good enough to replace computerised tomography and magnetic-resonance imaging—the most sophisticated medical-imaging tools that are routinely available today.

Refraction is the process by which X-rays (and other forms of electromagnetic radiation, such as light) change direction when they pass from one medium to another. The angle of change depends on the compositions of the two media. So if you pass a beam of X-rays through a living organism, the result will be a jumble of output beams caused by X-rays being refracted along different paths by different tissues in the organism's body.

Such a jumble is not, however, beyond analysis. A suitably programmed computer can make sense of it, and calculate the densities and positions of objects in the intervening body. The advantage of this jiggery-pokery is that the image produced is sharper and more detailed than anything that absorption-based radiology can deliver. Phase-contrast radiology, as Dr Margaritondo's technique is known, can “see” individual cells, cell walls and even structures inside cells. It can also take pictures so rapidly that they can be strung together into movies.

There is a disadvantage, however. Because the information is contained in the geometry of the beam, that beam must be precisely aligned to start with. This means that standard clinical X-ray sources are unsuitable—their rays tend to scatter in all directions. Instead, Dr Margaritondo and his team have been using machines called synchrotrons, which produce X-rays by bending high-energy electrons in a magnetic field. That yields beams with the desired characteristics. But synchrotrons are large and expensive, and so cannot be used routinely for clinical work.

So far, the team's research has been carried out on rats, insects and fish. But at the Sincrotrone Trieste, an Italian laboratory of which Dr Margaritondo was formerly scientific director, Giuliana Tromba and her colleagues are waiting for permission to start testing the technique on people. Dr Tromba proposes to use phase-contrast radiology as a tool for breast-cancer screening. If it fulfils its potential, it could get around one fundamental problem that arises with doing routine medical screening using X-rays: that the rays themselves may cause cancer.

For reliable screening, a good image quality is required, since any so-far-undetected cancer is likely to be small. With standard radiology, that means using a relatively high dose of X-rays, significantly increasing the risk that the screening itself will cause cancer in a previously healthy patient. But phase-contrast radiology should eliminate the risk.

If it works for breast cancer, phase-contrast screening could be extended to other complaints, such as coronary-artery disease, for which current techniques are too difficult or dangerous to be used routinely. That might, in turn, make it worthwhile to build more synchrotrons.

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Elephant poaching

Closing in for the kill?

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After a decade of quiet, ivory poaching has started again in Kenya

HEAPED together, tail to trunk, ten dead elephants lie stinking in the Kenyan sun. Their last panicked huddle made them a convenient target. The poachers who killed them, though, had no such instinct. They left behind five dead men, scattered along a 150km trail. The rest, including at least one who was badly wounded, limped back to Somalia, to report on the latest skirmish of the ivory war.

This slaughter of man and beast, in Tsavo East National Park last month, was Kenya's bloodiest poaching incident since 1987. But there could soon be worse. After a decade of mostly negligible poaching, large numbers of elephants are again being killed in the country. The Kenya Wildlife Service (KWS) found 57 killed for their ivory last year, and 18 in the past month alone. Six black rhinos have also been taken in recent months—the first for over a decade. And these finds, the KWS admits, may represent less than 15% of the total.

The international ivory trade has been illegal since 1989. Initially, that ban caused a market collapse. Now, the markets are recovering. The penchant of European tourists in Asia for ivory earrings and phalluses is helping to fuel demand. According to a recent report by Save the Elephants, a Kenya-based research organisation and lobby group, up to 80% of Asian elephant populations have been poached in the past 14 years in order to carve such knick-knacks. Africa's herds are making up the shortfall. On camel-back and bare shoulders, tusks are being ferried along ancient caravan routes from central Africa to Khartoum's souks. There, ivory prices have reached a 13-year high.

Such rising demand is one reason why poaching is picking up. Another is an expectation that the trade ban may be lifted, at least partly, at a meeting in November of the Convention on International Trade in Endangered Species (CITES), which governs such matters.

Kenya's elephant population is still in a precarious state. The country's herds were cut from 167,000 in 1973 to 16,000 in 1989, and have recovered only a little since then. Those in Botswana, Namibia and South Africa, however, are booming. These countries, along with Zimbabwe, whose elephant herd is in a more questionable condition, are lobbying to start trading in elephant products (mainly ivory, but also skins and meat) once again.

They are not asking for the ban to be lifted completely. Countries that wanted to keep their herds unculled could continue to shelter under the protection that CITES can offer: it would still be illegal to trade in elephant products from such countries in any place that had signed the convention. Kenya nevertheless opposes the southern Africans. The Kenyans do not have surplus elephants to trade, and they want to keep those they do have to encourage tourism. The government's view—shared less vociferously by Tanzania—is that even a minimal legal trade would encourage a massive illegal trade.

Even a minimal legal trade would encourage a massive illegal trade, in the view of Kenya's government

That belief is supported by anecdotal evidence, but it is difficult to prove. The failure of CITES to set up a proposed database known as MIKE (Monitoring the Illegal Killing of Elephants) leaves the matter open to debate. MIKE was supposed to include biennial surveys of all elephant populations and the routine collection of information such as the number of elephants killed illegally in particular places. Softer information, such as estimates of the effect of civil strife, and the involvement of local people in conservation, was also supposed to be assessed.

It was, however, the Kenyans themselves who criticised MIKE for being too expensive, and the whole project is in danger of running into the sand. Botswana, Namibia, South Africa and Zimbabwe,

meanwhile, argue that branding and spot genetic testing (the DNA of southern African elephants is distinguishable from that of East African ones) will be enough to detect and root out illegal trading. Kenya, to put it charitably, has doubts about that.

Whether a partial resumption of trade would finally do for Kenya's elephants remains to be seen. It may not be put to the test, for it is by no means certain that the southern African viewpoint will prevail at CITES. But the difficulty of bucking the market, whether legal or illegal, is well demonstrated by that pile of elephant corpses, and trail of human ones, in Tsavo. The KWS is famous for taking few prisoners. If even death is not a sufficient discouragement to poachers, it is difficult to see what else would be.

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Leaves on the line

Zap!

May 16th 2002
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Lasers could be the answer to late trains

BRITAIN'S railway companies may soon have to think of a new excuse for their late-running trains. If Malcolm Higgins, boss of a British firm called LaserThor, has his way, the old one of “leaves on the line” will no longer do.

Such leaves, let it be said, are no joke. Crushed under the wheels of engines and carriages, and pounded into a hard, shiny film, they can give steel rails the properties of a Teflon-coated frying-pan. That can cause braking trains to overshoot, with possibly fatal consequences. And stationary trains sometimes find it impossible to get moving at all.

At present, Railtrack, the company that runs Britain's railway infrastructure, clears such compacted leaves away by sending an army of cleaners round in the early hours of the morning. These cleaners are, however, armed with little more than glorified scrubbing brushes and knives.

Mr Higgins proposes to deal with the leaves in a rather more high-tech manner—by blasting them with a laser. The technology to do this has been developed by LaserThor in collaboration with scientists at the Rutherford Appleton Laboratory, near Oxford, and the Fraunhofer Institute for Technology in Aachen, Germany. It is unveiled in this month's *Physics World*.

LaserThor's leaf-clearer uses an infra-red pulsed laser mounted at the front of a train to produce a series of minute explosions that blow leaf residue from the rail they are aimed at, without damaging the steel itself. Two field-trials carried out so far suggest that the technique works well—certainly better than scattering crushed orange peel on to the rails to provide extra traction, one of the rival technologies that has been proposed.

Although LaserThor's equipment is too bulky to be fitted on active passenger trains, Mr Higgins thinks that it will be ideal for service vehicles that routinely scout the network for broken rails and points failures. It should reach the market next year—if it isn't held up by leaves on the line.

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Bioethics

It's not about miracles or monsters

May 16th 2002
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Corbis

A hands-on look at some hard, practical questions in bioethics

AMID so much hype and yammer in the suddenly fashionable field of bioethics, it is good to turn to a book by a professional philosopher with wide experience of how biomedical regulation works in practice. Onora O'Neill, the principal of Newnham College at Cambridge University, is known professionally in Britain as a moral and political theorist and—to a wider public—as the giver earlier this year of the BBC's Reith lectures, an annual series on an issue of lively concern.

Autonomy and Trust in Bioethics
By Onora O'Neill

Cambridge University Press; 228 pages; $55 and £40 (hardback); $20 and £14.95 (paperback)

Buy it at
Amazon.com
Amazon.co.uk

Her topic in the Reith lectures was restoring public trust in institutions, experts and authorities. Every enterprise, big or small, involves us in relying on others to get things right, she argued. And this sort of mutual trust, with its give-and-take and allowance for common error, cannot be supplanted by the ever more expensive techniques of arms-length supervision: audits, codes and performance league-tables. Teachers and doctors in Britain will recognise at once what she is talking about. Replace audits and codes with lawsuits and her ideas make immediate sense in an American context.

Overcoming distrust is the red thread also in her latest book, “Autonomy and Trust in Bioethics”, given as the Gifford lectures in Edinburgh last year. The subject area is medical practice, clinical trials and new techniques, particularly those involving genetics. The book has a philosophical and a practical side. Her more theoretical aim is to shift the idea of autonomy—roughly, patients and clinical subjects deciding for themselves—from centre stage, as autonomy often conflicts with other medical values such as preventing harm and improving health. She doubts that patients can in practice make fully informed decisions in complex cases.

Autonomy takes up the first four chapters, and non-philosophers will probably find this hard going. Philosophers, by contrast, may wonder which serious thinkers, as she seems to suggest, have ever nailed their colours to the crude idea that deciding for ourselves means deciding outside any rules or without regard to others.

In the last four chapters she gets down to cases. The overall effect is deflationary: she shows, example by example, how much better it is to argue about the rights and wrongs of techniques in the here and now than to dazzle or terrify ourselves with techno-futurology. She does not go on about the cloned humans, chimeras, drug- or chip-driven zombies, miracle cures and genetically enhanced super-people

that litter so many books in this field. Patiently and wisely she takes us through the forensic uses of DNA, medical screening by insurance companies and irksome who-to-tell questions that arise with rare, though horrible, late-onset genetic killers such as Huntington's disease.

She is not hostile to regulation, only to the wrong kind. Though recognising that the pace of innovation is fast, she rightly believes that in bioethics we should not try to run before we can crawl. As bioethics is not an ivory-tower pursuit of what's right, in her last two chapters she reviews ways to reach agreement on what's right—citizens' juries, consultations, plebiscites, for example. She also rebukes Britain's serious press for its frivolous sensationalism towards biomedicine.

One of her merits is to avoid two beguiling gas balloons that obscure our view. The first is an overblown fear—not limited to religious believers—that biomedicine and brain science are about to transform our natures, wiping out our ability to tell right from wrong. The other is the fraudulent promise that technology will free us all from unhappiness and infirmity, prolong life and provide parents with brainy, well-adjusted children untouched by genetic handicap. Between these two romantic visions—the technophobes' “Invasion of the Body Snatchers” and the technophiles' “Miracle at Fatima”—lies working room a-plenty. Onora O'Neill uses it well. “Autonomy and Trust in Bioethics” is focused on Britain. But its lessons are general. It should be read by everyone concerned with this topic.

Autonomy and Trust in Bioethics.
By Onora O'Neill.
Cambridge University Press; 228 pages; $55 and £40 (hardback); $20 and £14.95 (paperback)

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Horse racing

Stout of heart

May 16th 2002
From The Economist print edition

HORSE racing is not for the faint- hearted. Nor is it for the little man, which is why a tale about someone who beat the odds has all the makings of a winner.

Jim Squires is a former editor of the *Chicago Tribune*, who came to horse breeding late in life when he sank much of his pay-off from the paper into a bankrupt Kentucky stud farm. Mr Squires chronicles the trials and tribulations of breeding horses at the bottom end of the market. Much of his book, inevitably, is devoted to Monarchos, a runner that he bred from a cheap stallion and a cast-off mare, and which—you've guessed it—went on to win the 2001 Kentucky Derby.

This was indeed a feat, but Mr Squires's book is hardly a match for “Seabiscuit”, last year's racing sensation. Monarchos was more a one-race fluke than a true champion. And the book is marred by avoidable errors. Yes, Michael Tabor, a British owner and breeder, made his fortune from a chain of betting shops. But its name was Arthur Prince not Prince Arthur. For Mr Squires, the Derby was a better bet.

Horse of a Different Color.
By Jim Squires.
PublicAffairs; 320 pages; $26 and £17.99

Horse of a Different Color
By Jim Squires

PublicAffairs; 320 pages; $26 and £17.99

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About sponsorship

Colombia's conflicts

Absent friends

May 16th 2002
From The Economist print edition

IT IS not often that a presidential candidate is prevented from voting—or being voted for—because of a kidnapping. But then, this is Colombia.

Three months ago, just as the president, Andres Pastrana, called off three years of futile talks with the FARC guerrillas, Ms Betancourt, an outspoken and sometimes derided senator, was snatched by the rebels. The only news since has been a statement by her captors that they would like to swap her for some imprisoned guerrilla commanders.

The author's plight hangs over this memoir, which first appeared in French last year. It adds poignancy to the portrait of her father, a distinguished former education minister who failed as a political reformer. Ms Betancourt confesses to living with “the constant fear” that her father will die when she is “far away”. He died less than a month after her kidnap. And there is also a premonitory edge to the author's musings about the dangers involved in trying to be an honest politician in Colombia.

Until Death Do Us Part: My Struggle to Reclaim Colombia
By Ingrid Betancourt and translated from the French by Steven Rendall

Ecco; 240 pages; $24.95.
Harper Collins; £14.99

Buy it at
Amazon.com
Amazon.co.uk

Ms Betancourt's personal history gives her an ambivalent relationship with her country. Born into the Colombian political class of which she is witheringly critical, she lived much of her life—she is only 41—safely abroad. She was partly educated in Paris, and married a French diplomat with whom she had two children. In 1989, when Luis Carlos Galan, a reformist politician and friend of her mother's, was murdered by Pablo Escobar, the drug trafficker, Ms Betancourt tore up the script for her life as a diplomatic wife, returned to Colombia and plunged into politics.

She became a moral crusader against corruption. Her contacts and flair for political marketing won her election, first as a Liberal congresswoman in 1994, and four years later as an independent senator. Her message chimed with the mood of the moment. In 1994, Ernesto Samper's successful campaign for the country's presidency had been financed partly by the Cali drug mob. The resulting scandal (and cover-up, according to Ms Betancourt) dominated political life in the mid-1990s.

Ms Betancourt waged a courageous, though ultimately ineffective, campaign for political reform, yet her claim to have been almost alone in opposing Mr Samper is somewhat exaggerated. Sadly, her message was largely restricted to denunciation, and the voters quickly grasped that. She was kidnapped when she ignored security advice, and rushed to be the first candidate to enter a FARC enclave retaken by the army after the talks collapsed. It was a brave act, but also naive. And since Colombia's current mood is one of utter weariness with endemic rebel violence and a rejection of any further appeasement, Ms Betancourt faces, at best, a long captivity.

In France, her kidnap is seen as a national affront. In Colombia, by contrast, she has been swiftly forgotten. Those who feel that she somehow deserved her fate are wrong. However self-righteous, her campaigns added badly-needed credibility to Colombia's democracy. Her absence underlines the many threats that it faces.

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Jazz biography

So long, angel

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NOT many jazz musicians become icons, but in the 1950s Chet Baker was the thing itself. He had little formal training on trumpet, but there was no doubt as to his talent. As a colleague put it, “I've never been around anybody who had a quicker relationship between his ears and his fingers.” Even more compelling was the disarming lyricism of his style, a kind of sweet simplicity which seemed a natural extension of his appearance. Women swooned over him, as did photographers, one of whom said that Chet Baker made him realise what it meant to be photogenic. And if the face and the horn weren't enough, there was his singing, which he did equally naturally and in his own way, making a speciality of yearning ballads like “My Funny Valentine”.

Deep in a Dream: The Long Night of Chet Baker
By James Gavin

Knopf; 413 pages; $26.95.
Chatto and Windus; £20

Buy it at
Amazon.com
Amazon.co.uk

Thus equipped Baker became a jazz pin-up, the Beach Boy of his day, the epitome of the sweet life in California. Unfortunately, as James Gavin's detailed and perceptive biography reveals, there was something unreal about the trumpeter from the beginning. Early on, a friend observed that behind his “saintly-looking” façade lurked “a pretty dangerous little bastard”. It wasn't so much that Baker was evil, but he was simply oblivious to anything but his own drives and desires, which for most of his life were defined by a fierce devotion to drugs. Feeding his habit became his raison d'être, jazz merely a means to that all-consuming end. And when jazz didn't provide the necessary funds, he turned readily to petty crime, which, along with the addiction, kept him in constant trouble with the law.

The worst part of this harrowing chronicle is Baker's treatment of other people, particularly women, whom he could still charm with a kind of specious, fallen-angel sincerity. He never lost what Mr Gavin calls his “duplicitous allure”, and several partners found themselves the prisoners of his wheedling need. He invariably presented himself as a victim, a free spirit whose simple wish to play his music and live his life was thwarted by a callous world. But as a fellow musician said: “Chet was an absolute realist. He didn't have a romantic bone in his body or a naive one. All Chet cared about was getting high.”

Toward the end of his life—in 1988, probably by suicide—he became a kind of icon of destruction, his baby-face ravaged, his playing spare, often fumbling, but still affecting. In Europe particularly he was regarded as “a wise old poet”. But as one friend said, “He'd been a junkie so long that his soul was gone. It was very hard to understand where the beautiful music came from.”

Deep in a Dream: The Long Night of Chet Baker.
By James Gavin.
Knopf; 413 pages; $26.95.
Chatto and Windus; £20

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New fiction

Dark heart

May 16th 2002
From The Economist print edition

“A SCANDALOUS WOMAN”, a short story by Edna O'Brien, suggested already in 1974 that its author might eventually turn to darker themes. “I thought ours indeed was a land of shame, a land of murder and a land of strange, throttled, sacrificial women,” its narrator concludes.

In two recent novels, “House of Splendid Isolation” and “Wild Decembers”, Ms O'Brien fastened on real events to explore in fiction the undersides of Ireland. She does so again in her new novel, “In the Forest”. The abduction and murder in County Clare eight years ago of a priest, a mother and her young child by an itinerant Irishman, Brendan O'Donnell, shocked many people—especially as the killer claimed he'd been driven to it by the devil. Ms O'Brien, in turn, has angered the relatives of O'Donnell's victims by seeking to explore the state of mind of their killer in the form of a novel.

In the Forest
By Edna O'Brien

Houghton Mifflin; 264 pages; $24.
Weidenfeld & Nicolson; £16.99

Buy it at
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Amazon.co.uk

With its black-hearted woods and its scary monster—what she calls the Kinderschreck—taking revenge on an entire community by seeking innocent human sacrifices, “In the Forest” has all the ingredients of an ancient folktale. Michen O'Kane hides in the forest from an early age to escape his father's violence. His mother is his only source of love, but this dries up at her death. Without her, the world is scary and friendless. At the age of ten he steals a gun “to keep him safe”, cuddling it and calling it Rod as another child might a teddy bear. O'Kane's delinquent behaviour sends him to some appalling institutions where he is subjected to physical and sexual violence. He learns to “stopper the tears up, like putting a cork in a bottle”.

Ms O'Brien shows us what it is that “warps a child...that changes a child from being a child”. Michen O'Kane brims with a rage that is waiting to be loosed. The young heroine, Eily—attractive woman and loving mother—is the embodiment of O'Kane's distorted picture of womanhood, “all mothering, all sinning”. She and the priest, Father John, become instruments of something outside themselves, “iconic, picked from a thousand faces for wanton ritual”. Yet Ms O'Brien will not let us see these people as symbolic victims. We are offered details of their lives that remind us constantly of their humanity. We watch the terrible process as both Eily and Father John, abducted at gun point by O'Kane, struggle to reach and keep hold of his flashes of sanity, when he seems to see them as fellow humans. They try to “get him stable” and in the process offer him a sympathy which is tragically several years too late. The damage has been done.

This is a shocking story of a crime that reverberates far beyond the people directly involved and their small community. It carries implications we must all face—in the words of O'Kane's grandmother, “we're all of us broken by this and we won't mend.” It recalls, perhaps inevitably, Gitta Sereny's “Cries Unheard”, an exposition of the life of Mary Bell, a child murderess. Both books make the important point that we are, as a society, responsible for the crimes committed by young people if we fail to heed the signs that they are nearing a crisis. By fictionalising her account, Ms O'Brien allows herself an imaginative freedom which gives the story a new life, sharpening the sense of horror and the lost opportunity, while at no point allowing us to forget its truth.

In the Forest.
By Edna O'Brien.
Houghton Mifflin; 264 pages; $24.
Weidenfeld & Nicolson; £16.99

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African non-fiction

Bloody memories

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From The Economist print edition

AFRICA is not a kind continent. The rawness that many Europeans and Americans encounter mostly in action films are in Africa the props of everyday life. Despite this rich material, most recent memoirs have been the preserve of white writers such as Rian Malan, Peter Godwin, Kuki Gallmann and, just this year, Alexandra Fuller. Their engagement with the cruel continent is sensitive and eloquent. But it remains also stubbornly unAfrican.

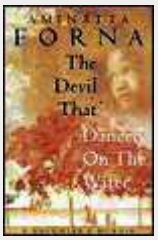
Aminatta Forna is the daughter of a British mother and Sierra Leonean father who, while at medical school in Scotland, celebrated his nation's independence by puffing away on six cigarettes in one go. “I'm smoking for freedom, man,” he declared. After he returned to Freetown, Mohamed Forna was sucked into politics. He was appointed minister of finance by the moody and unpredictable Siaka Stevens, who, seven years later, had him tried on trumped-up charges and hanged for treason.

Three times Ms Forna and her two sisters were sent into exile for their safety. First, with their mother they lived in Scotland, squeezing themselves into a caravan in a field because landladies wouldn't rent to “foreigners”. Later, after their parents divorced and remarried, it was the Forna girls' heroic new African stepmother who watched over them, raising money (from Tiny Rowland, among others) and making sure they did their homework.

In 2000, Ms Forna, by now a documentary film maker for the BBC, flew back to Sierra Leone to try and find the truth behind her father's execution and the men who ordered it. Stevens was dead, and much of the country was ruled by Foday Sankoh's bestial RUF rebels. Many of those who voted in this year's presidential election had to do so with their big toe; both hands had been amputated. Ms Forna recounts how she found the trial transcript and persuaded those responsible to speak to her. But she also explores the symbolism of her journey, and how the loss of her father and the years in exile echo an Africa that lost its hopes and dreams, and then lost the plot. Hers is an African memoir unlike any before it.

The Devil That Danced On The Water: A Daughter's Memoir.
By Aminatta Forna.
HarperCollins; 403 pages; £17.99

The Devil That Danced On The Water: A Daughter's Memoir
By Aminatta Forna



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About sponsorship

Film history

A dark and laughing ringmaster

May 16th 2002
From The Economist print edition

We celebrate one of cinema's true greats, born 100 years ago this month

THE films of Max Ophuls (1902-57) are renowned for their formal brilliance, especially the fluidity of their camerawork. James Mason, the British actor who worked with Ophuls in Hollywood, penned a little rhyme about him:

> A shot that does not call for tracks
> Is agony for poor old Max,
> Who, separated from his dolly,
> Is wrapped in deepest melancholy.
> Once, when they took away his crane,
> I thought he'd never smile again.

Smile, in fact, Ophuls always did, even in the most adverse circumstances, and he was famous for his infectious laughter.

He was exemplary in many ways, and not just for his craftsmanship, in which he was comparable only to Hitchcock. He stands out for what his career has to tell us about the interaction of art and politics in the 20th century. In 1933 he had to flee from Germany. In 1940 he had to flee again, this time from France to America. There followed poverty and unemployment in the exile community in California until he finally got a chance in Hollywood. He returned to Europe in 1950, first to France and then tentatively to his homeland, Germany, which, in spite of everything, he still loved.

Born in Saarbrücken into a well-off Jewish family, the young Max Oppenheimer took the name Max Ophüls when he left home at the age of 18 to join the theatre. (Later, when he became a French citizen, he dropped the umlaut, becoming Ophuls; in Hollywood he was called Opuls.) A talented apprentice director, in 1925 he was asked to work at the prestigious Burgtheater in Vienna. He was hired under his stage name and it was only when he used his real name to sign the contract that the theatre realised he was a Jew. He lasted six miserable months in Vienna before his contract was terminated and he returned to Germany. It was his first experience of anti-Semitism. In 1930, after working his way up the theatre hierarchy to fully-fledged director, he suddenly changed course and took a job in the UFA studio in Berlin as dialogue coach, assisting a Kiev-born film director, Anatole Litvak, in the theatrical skills demanded by the recently introduced talking picture. Soon he became a film director, and by 1932, with “Liebelei”, adapted from a play by Arthur Schnitzler, a worldwide success.

Throughout his enforced migrations Ophuls had to come to terms with different languages and different cultures, and to explore the boundaries of what was commercially and artistically possible in different production systems—precarious and freewheeling in France, regimented in America. Constantly on the move, at the mercy of opportunist producers, he made an imaginary home for himself in the world of the *ancien régime*. Over half of his films are set in the 19th and early 20th centuries, four of them in Habsburg Vienna.

His choice of odiously anti-Semitic Vienna is no accident. “Vienna, about 1900”, as the opening title of his most famous Hollywood film “Letter from an Unknown Woman” (1948) declares itself, is the Vienna of the *Sezession*, Schnitzler and, above all, Freud. Ophuls's imaginary Vienna is a world about to be destroyed and one in which the glossy surface is fissured by cracks which expose its cruelty and hypocrisy. His gliding camera explores the surface, exulting in the beauty of what it sees but ever attentive to the potential for calamity that lies beneath. A master of human psychology, he devotes particular attention to women. His heroines, often of a lower class, push their way into a world in which aristocrats, officers and bankers hold sway. The heroine's charm captivates for a while, but one false step

and she will be cruelly cast aside. Her lover will perish with her, most likely in a duel.

This darker side is ever there beside the laughter and generosity. In “Lola Montes” (1955), the once proud Lola, mistress of Franz Liszt and of the King of Bavaria, is a caged beast, enacting the story of her rise and fall in an American circus under the control of a sadistic ringmaster (Peter Ustinov). Ophuls's clear love is for Lola, played by Martine Carole (shown with him above). But he is also the ringmaster, and therefore we, the audience, are like those who crowd into the circus to watch herhumiliation. Ophuls's readiness to confront the darker side of desire makes him more than a craftsman, more than a classy entertainer touting mid-European culturedness; it makes him, in fact, one of cinema's greatest artists.

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A short turn among Ophuls classics

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CAROUSELS, circus rings, dance floors and, above all, stairs: people in Max Ophuls's world are seldom still. Lovingly tracked by his favourite cameramen, Franz Planer and Christian Matras, they move with an ease rarely captured on film. Yet their happiest moments dissolve, desire is never one-sided and freedom is always constrained. His films were often what *Variety* calls “costumers”. But his vision was not limited to a time, and he was one of the most cosmopolitan of directors.

His masterworks are “Liebelei” (1932), “La Signora di Tutti” (1934), “Letter from an Unknown Woman” (1948), “Caught” and “The Reckless Moment” (1949), “La Ronde” (1950), “Madame De...” (1953) and “Lola Montes” (1955). See them if you can, even on video. You may recapture the magic of watching films as a child—with the eyes of an adult.

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About sponsorship

Joseph Bonanno

May 16th 2002
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Joseph Bonanno, an American gangster, died on May 11th, aged 97

AP

A DISCOVERY made by Joseph Bonanno when he was quite young was that in a democracy it is possible to construct a criminal organisation largely immune from the law. The American constitution with its constraints designed to protect citizens from unfair prosecution could also be used to shield criminals providing there was enough money available to employ clever lawyers to manipulate the system. Confident of his protection, Mr Bonanno assembled an empire of crime with a turnover of billions of dollars. Despite the best efforts of the state, Mr Bonanno was never convicted of a serious crime. The state's successes were meagre. Mr Bonanno was once fined $450 on a minor charge and late in life was jailed for terms of eight and 14 months for refusing to answer questions, an offence deemed to be contempt of court. The FBI tried to track his every move, even searching Mr Bonanno's dustbins for incriminating evidence. It ended up only looking foolish.

Al Capone, a gangster of America's prohibition era, seems to have been Joseph Bonanno's mentor, teaching him that, with money, you could get away with murder. Capone was jailed (for income tax evasion) in 1931, and Joseph Bonanno moved on. He had been born in Sicily and had links with the semi-feudal Sicilian families collectively known as the Mafia. When Benito Mussolini took power in Italy in 1922 he jailed many Mafia followers, accusing them, correctly, of gangsterism. Those that could get away fled to the United States. The Mafia flourished again in Italy only after the country surrendered in the second world war. By then Mr Bonanno's American branch of the Mafia, consisting mainly of gangs run by Italian émigrés, was flourishing. Each had its speciality: drugs, prostitution, protection, gambling, whatever. Sometimes there were power struggles, and gangsters would murder each other, cheering up the FBI. Mr Bonanno rose in the 1960s to be the *capo di tutti i capi*, boss of bosses. He was said to have invented the “double coffin” in which the body of someone who had died naturally would conceal a murdered corpse. He was a careful man.

The tradition

If Joseph Bonanno had a weakness it was his desire for respectability. It was a difficult ambition, perhaps an impossible one. Mr Bonanno was a criminal. Everyone knew that, and criminals, even successful ones, are not respectable. Shakespeare, as always, put it rather well, noting that, however rich you were, the loss of a good name “makes me poor indeed”. Mr Bonanno was not a literary man, although he did once get someone to help him write a book about himself called, seemingly without irony, “A Man of Honor”. In reviewing his career he says

> The way of life I and my friends had chosen was but a means to attain social advancement and respectability. We didn't consider ourselves criminals.

In his campaign of denial Mr Bonanno relied on what he called “my tradition”, a phrase often used by the mafiosi. He denied that he had dealt in drugs because “my tradition” outlawed them. He had nothing to do with prostitution because it was against “my honour”. And so on. He sued the publishers of a paperback edition of “A Man of Honor” for depicting him on the cover as “a cheap gangster”.

Pressed for a description of himself Mr Bonanno offered “venture capitalist”: indeed much money from his criminal activities was used to set up orthodox businesses such as hotels. He called his group of gangs “the commission” and he was “chairman”. In another flight of fancy he said his work was like running a

state. He had to maintain internal order and to conduct diplomatic relations with other leaders. Despite the self-flattery, there was an element of truth in it. Mr Bonanno was a dictator with absolute power over his subjects. Japan's tolerated gangsters, the Yakuza, have been compared to the Bonanno empire. But they have never gained the same sort of immunity, perhaps because Japan is a more rigid society.

The Mafia remains a sore in Italy (see article). It has corrupted sections of Italian politics. Judges and priests, among others, brave enough to stand up to it have been murdered. That, however, is not how the Mafia has often been portrayed in books and films about its American branch. The most famous is Mario Puzo's romantic novel “The Godfather”, said to have been based on Mr Bonanno. Unlike its characters, real mafiosi are just as likely to be podgy and their women plain, and to have never uttered a witticism in their lives. “The Sopranos”, an American television series, continues the theme of fictional mafiosi.

Joseph Bonanno may have been the first Mafia godfather to die naturally. But he did not feel that he had been well treated by America. He said he resented being “hounded” by the FBI. Newspapers and television had been disrespectful. It was hurtful to be known as “Joe Bananas”. Despite his dedicated work as chairman of the “commission”, he had once had to disappear for two years for fear of ending up in a double coffin. Unlike other fathers he had been unable to enjoy watching his three children growing up in a quiet rural suburbia. He had had a precarious life. The heart bleeds.

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Overview

May 16th 2002
From The Economist print edition

Inflation in **America** rose by more than expected in April, though not by enough to force the Fed to raise rates in the short term. Consumer prices rose by 0.5% in April, making a 1.6% rise over the year. Petrol prices were responsible for most of the increase, but sellers of manufactured goods still have little pricing power. Producer prices fell by 2.0% in the year to April.

American consumers' appetites are still healthy. In April, retail sales grew by 1.2%, their fastest pace since September 11th, against expectations of a 0.7% increase.

America's factories are getting busier. Industrial production rose by 0.4% in April, but was still down by 2.0% over the previous year. Capacity utilisation saw a slight rise, from 75.3 in March to 75.5 in April; but this is not enough to calm fears of excess capacity.

Spain's consumer prices rose by 3.6% in the year to April. Some analysts blame the rounding up of retail prices in the wake of the conversion of pesetas into euro notes and coins. Consumer prices in the **Netherlands** also rose by 3.6% in the same period.

In the year to the first quarter, **Italy's** economy grew by 0.1%, the slowest pace since 1997. In the year to March, industrial production suffered a 7.6% drop.

Germany's trade surplus widened in March to $10.4 billion, taking the 12-month total to $92.3 billion. Retail sales fell by 4.5% in volume in the year to March; producer prices fell by 0.5% in the year to April.

Swedish consumer prices rose by 2.5% in the year to April; retail sales grew by 4.3% in volume in the year to March. In the year to April, **Danish** consumer prices rose by 2.4%; producer prices rose by 0.3%.

Japan's narrow-money supply expanded by 32.6% in the 12 months to April. But broad-money supply saw far weaker 12-month growth, slowing to 3.6% in April from 3.7% in March. The trade surplus widened in March to $7.8 billion, taking the 12-month total to $72.6 billion; the current-account surplus also rose, giving a yearly total of $96.1 billion. Producer prices fell by 0.7% in the year to April.

The number of people claiming unemployment benefit in **Britain** rose in April, taking the unemployment rate to 3.2%. Wages rose by 2.9% in the year to March, and producer prices rose by 0.2% in the year to April.

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Output, demand and jobs

May 16th 2002
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% change at annual rate

	GDP			The Economist poll GDP forecasts		Industrial production		Retail sales (volume)		Unemployment % rate		
	1 qtr	1 year		2002	2003	latest		latest		latest		year ago
Australia	+ 5.2	+ 4.1	Q4	+ 3.8	+ 3.9	+ 2.5	Q4	+ 5.0	Q1	6.3	Apr	6.7
Austria	– 0.7	– 0.4	Q4	+ 1.3	+ 2.7	– 0.2	Feb	+ 0.7	Jan	4.0	Mar	3.4
Belgium	– 1.7	– 0.7	Q4	+ 1.4	+ 3.1	–10.8	Mar	+ 6.6	Feb	10.5	Apr*	10.2
Britain	+ 0.3	+ 1.0	Q1	+ 1.9	+ 2.9	– 5.9	Mar	+ 5.7	Mar	5.1	Mar†	5.1
Canada	+ 2.0	+ 0.9	Q4	+ 2.7	+ 3.5	– 0.8	Feb	+ 6.6	Feb	7.6	Apr	7.0
Denmark	+ 0.5	+ 0.4	Q4	+ 1.6	+ 2.5	nil	Mar	+ 2.1	Feb	5.0	Mar	5.4
France	– 1.4	+ 0.5	Q4	+ 1.5	+ 2.9	– 0.4	Mar	– 0.1	Mar	9.1	Mar	8.7
Germany	– 1.0	– 0.1	Q4	+ 1.0	+ 2.6	– 3.8	Mar	– 4.5	Mar	9.6	Apr**	9.4
Italy	+ 0.6	+ 0.1	Q1	+ 1.4	+ 2.9	– 7.6	Mar	– 0.4	Feb	9.0	Jan	9.8
Japan	– 4.8	– 1.9	Q4	– 1.0	+ 1.1	–10.0	Mar	– 4.3	Mar	5.2	Mar	4.7
Netherlands	nil	+ 0.4	Q4	+ 1.5	+ 3.0	– 2.0	Mar	+ 0.8	Feb	2.2	Mar§	2.2
Spain	+ 0.7	+ 2.3	Q4	+ 2.1	+ 3.3	– 9.3	Mar	na		12.9	Mar	13.1
Sweden	+ 1.4	+ 1.1	Q4	+ 1.8	+ 3.0	– 1.7	Feb	+ 4.3	Mar	3.8	Mar*	3.9
Switzerland	+ 0.1	+ 0.4	Q4	+ 1.1	+ 2.3	– 1.0	Q4	+ 0.9	Mar	2.5	Apr*	1.7
United States	+ 5.8	+ 1.6	Q1	+ 2.8	+ 3.5	– 2.0	Apr	+ 6.1	Mar	6.0	Apr	4.5
Euro area	– 0.8	+ 0.7	Q4	+ 1.3	+ 2.9	– 3.3	Feb	+ 1.3	Feb	8.4	Mar	8.5
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*											
Finland	– 1.8	– 0.9	Q4	na	na	– 4.9	Mar	+ 1.3	Jan	9.5	Mar*	9.6
Greece	na	+ 3.7	Q4	na	na	– 2.0	Feb	+ 8.4	Jan	na		na
Iceland	na	+ 3.1	2001	na	na	+ 3.3	2001	na		2.7	Mar*	1.5
Ireland	na	nil	Q4	na	na	+14.7	Mar	+ 5.0	Feb	4.2	Apr	3.6
Luxembourg	na	+ 3.5	2001	na	na	+ 2.4	Feb	+ 5.4	Dec	2.8	Mar	2.6
New Zealand	+ 2.6	+ 2.9	Q4	na	na	+ 3.5	Q4	+ 8.2	Q1	5.3	Q1	5.4
Norway	+ 1.0	+ 1.8	Q4	na	na	– 2.5	Mar	+ 2.9	Mar	3.7	Q1	3.7
Portugal	+ 1.8	+ 1.0	Q4	na	na	+ 2.3	Mar	– 0.4	Mar	4.1	Q4*	3.8

*Not seasonally adjusted. †Jan-Mar; claimant count rate 3.2% in Apr. §Jan-Mar. **EU harmonised rate 8.1% in Apr.

Text refers only to the first 16 countries listed

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Prices and wages

May 16th 2002
From The Economist print edition

% change at annual rate

	Consumer prices			The Economist poll consumer prices forecast		Producer prices			Wages/earnings		
	latest		year ago	2002	2003	latest		year ago	latest		year ago
Australia	+ 2.9	Q1	+ 6.0	+ 2.5	+ 2.5	+ 0.5	Q1	+ 5.2	+ 4.9	Q4	+ 5.4
Austria	+ 1.9	Mar	+ 2.7	+ 1.7	+ 1.7	– 0.5	Apr	+ 2.9	+ 2.4	Mar	+ 2.6
Belgium	+ 1.8	Apr	+ 2.8	+ 1.9	+ 1.7	+ 0.4	Mar	+ 3.2	+ 3.1	Q1	+ 1.9
Britain	+ 1.3	Mar	+ 2.3	+ 2.1	+ 2.5	+ 0.2	Apr	+ 0.6	+ 2.9	Mar	+ 5.0
Canada	+ 1.8	Mar	+ 2.5	+ 1.5	+ 2.0	– 1.2	Mar	+ 2.4	+ 3.3	Feb	+ 0.3
Denmark	+ 2.4	Apr	+ 2.7	+ 2.1	+ 2.1	+ 0.3	Apr	+ 3.6	+ 4.1	Q4	+ 3.8
France	+ 2.0	Apr	+ 1.8	+ 1.6	+ 1.5	– 0.7	Mar	+ 2.9	+ 4.1	Q4	+ 5.0
Germany	+ 1.6	Apr	+ 2.9	+ 1.5	+ 1.4	– 0.5	Apr	+ 4.1	+ 2.3	Feb	+ 2.4
Italy	+ 2.4	Apr	+ 3.1	+ 2.0	+ 2.0	– 1.3	Mar	+ 4.2	+ 3.2	Mar	+ 2.0
Japan	– 1.2	Mar	– 0.7	– 1.0	– 0.6	– 0.7	Apr	+ 1.3	– 1.0	Mar	+ 0.6
Netherlands	+ 3.6	Apr	+ 4.9	+ 3.3	+ 2.5	– 1.8	Mar	+ 5.7	+ 3.8	Mar	+ 4.2
Spain	+ 3.6	Apr	+ 4.0	+ 2.5	+ 2.4	nil	Mar	+ 3.2	+ 3.7	Q4	na
Sweden	+ 2.5	Apr	+ 2.8	+ 2.4	+ 2.1	– 0.4	Mar	+ 2.6	+ 2.6	Feb	+ 2.8
Switzerland	+ 1.1	Apr	+ 1.2	+ 0.7	+ 1.1	– 1.3	Mar	+ 0.5	+ 2.5	2001	+ 1.3
United States	+ 1.6	Apr	+ 3.3	+ 1.5	+ 2.3	– 2.0	Apr	+ 3.7	+ 3.4	Apr	+ 4.3
Euro area	+ 2.2	Apr	+ 2.9	+ 1.9	+ 1.7	– 0.8	Mar	+ 4.2	+ 3.0	Q4	+ 2.5
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*										
Finland	+ 1.8	Apr	+ 2.9	na	na	– 0.8	Mar	+ 2.1	+ 4.3	Q4	+ 5.0
Greece	+ 3.8	Apr	+ 3.5	na	na	+ 3.7	Mar	+ 4.3	na		na
Iceland	+ 5.9	May	+ 5.5	na	na	+ 8.8	Apr	+ 4.2	+ 8.7	Mar	+ 9.2
Ireland	+ 4.8	Apr	+ 5.6	na	na	+ 1.4	Mar	+ 3.1	+ 8.1	Q4	+ 6.4
Luxembourg	+ 2.1	Apr	+ 2.8	na	na	– 2.5	Feb	+ 4.5	+ 3.1	Feb	+ 4.8
New Zealand	+ 2.6	Q1	+ 3.1	na	na	+ 1.8	Q4	+10.7	+ 2.1	Q1	+ 1.8
Norway	+ 0.5	Apr	+ 3.8	na	na	– 4.7	Apr	+ 9.8	+ 4.5	Q4	+ 4.3
Portugal	+ 3.6	Apr	+ 4.5	na	na	– 5.0	Mar	+ 4.7	+ 2.4	Apr	na

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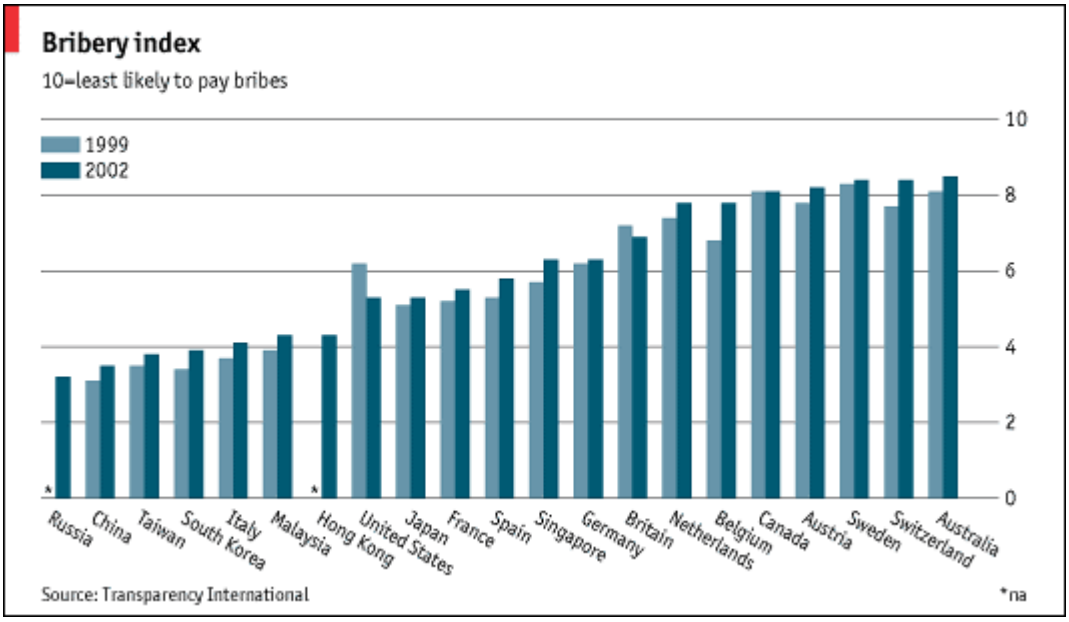
Bribery index

May 16th 2002
From The Economist print edition



According to Transparency International, an anti-corruption organisation, Russian and Chinese companies are paying bribes in developing countries “on an exceptional and intolerable scale”. In rich countries, companies from Italy, America and Japan score poorly, despite their anti-bribery laws and conventions. American and British companies' record, reckons Transparency International, has deteriorated since 1999.

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Money and interest rates

May 16th 2002
From The Economist print edition

	Money supply* % change on year ago			Interest rates % p.a. (May 15th 2002)					
				3-mth money market		2-year	10-year gov't bonds		corporate
	narrow	broad		latest	year ago	gov't bonds	latest	year ago	bonds
Australia	+19.0	+13.9	Mar	4.87	4.88	5.43	6.35	6.10	7.40‡
Britain	+ 7.2	+ 5.4	Mar	4.09	5.16	4.82	5.30	5.02	6.17
Canada	+11.7	+ 5.3	Mar	2.54	4.28	4.28	5.76	5.96	7.11
Denmark	+ 5.8	+ 5.3	Mar	3.80	4.95	4.56	5.41	5.30	7.03
Japan	+32.6	+ 3.6	Apr	0.02	0.02	0.02	1.35	1.28	1.46
Sweden	+ 8.8	+ 6.2	Dec	4.28	3.98	5.13	5.66	5.24	5.77
Switzerland	+ 6.6	+ 3.1	Mar	1.28	3.12	2.10	3.32	3.40	4.28
United States	+ 7.1	+10.0	Mar	1.81	3.95	3.33	5.25	5.45	7.06
Euro area†	+ 5.8	+ 7.3	Mar	3.49	4.56	4.35	5.18	5.01	6.05

*Narrow: M1 except Britain and Sweden M0, broad: M2 or M3 except Britain M4. † Germany for bonds. ‡ New series. Benchmarks: US 30-year 5.73%, Japan No.238 1.36%. Central bank rates: US fed funds 1.75%, ECB refinancing 3.25%, BOJ overnight call 0.001%, BOE repo 4.00%. Sources: Commerzbank, Danske Bank, J.P. Morgan Chase, Royal Bank of Canada, Stockholmsbörsen, UBS Warburg, DRI-WEFA, Westpac, Thomson Financial Datastream. Rates cannot be construed as banks' offers.

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The Economist commodity price index

May 16th 2002
From The Economist print edition

1995=100

	May 7th	May 14th*	% change on one month	% change on one year
Dollar index				
All items	68.0	68.8	– 0.3	– 3.8
Food	67.5	68.7	– 1.1	+ 0.1
Industrials				
All	68.7	69.0	+ 0.9	– 8.5
Nfa†	69.4	69.6	+ 1.9	– 7.0
Metals	68.1	68.5	+ 0.0	– 9.8
Sterling index				
All items	73.2	75.0	– 0.9	– 5.5
Euro index				
All items	98.0	100.4	– 2.3	– 6.2
Yen index				
All items	92.6	94.3	– 2.1	+ 0.4
Gold				
$ per oz	312.40	307.75	+ 3.1	+15.1
West Texas Intermediate				
$ per barrel	26.98	29.08	+15.5	+ 0.8

* Provisional. † Non-food agriculturals.

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Stockmarkets

May 16th 2002
From The Economist print edition

Market indices

	May 15th	2002 high	2002 low	% change on one week	% change on record high	% change on Dec 31st 2001 in local currency	% change on Dec 31st 2001 in $ terms
Australia (All Ordinaries)	3,324.7	3,440.0	3,252.2	+ 1.1	- 3.4	- 1.0	+ 6.1
Austria (ATX)	1,335.6	1,357.2	1,114.4	- 0.5	-23.1	+17.1	+19.3
Belgium (Bel 20)	2,871.7	2,899.8	2,622.4	+ 1.1	-22.0	+ 3.2	+ 5.1
Britain (FTSE 100)	5,259.1	5,323.8	5,024.1	+ 1.0	-24.1	+ 0.8	+ 0.8
Canada (Toronto Composite)	7,707.0	7,958.1	7,418.1	- 0.0	-32.3	+ 0.2	+ 2.9
Denmark (KBX)	221.4	233.4	213.3	- 2.0	-26.6	- 1.5	+ 0.3
France (SBF 250)	2,964.1	3,081.9	2,694.1	+ 1.5	-32.5	- 0.6	+ 1.3
(CAC 40)	4,471.3	4,688.0	4,239.0	+ 1.5	-35.4	- 3.3	- 1.5
Germany (Xetra DAX)	5,072.4	5,462.6	4,745.6	+ 0.9	-37.1	- 1.7	+ 0.1
Italy (BCI)	1,451.7	1,513.0	1,344.9	+ 1.2	-33.5	+ 1.3	+ 3.1
Japan (Nikkei 225)	11,643.0	11,919.3	9,420.9	+ 1.1	-70.1	+10.4	+13.2
(Topix)	1,087.0	1,125.4	922.5	+ 0.5	-62.3	+ 5.3	+ 7.9
Netherlands (AEX)	503.8	531.2	478.3	+ 1.2	-28.2	- 0.6	+ 1.2
Spain (Madrid SE)	830.0	848.1	773.2	+ 0.8	-27.6	+ 0.7	+ 2.5
Sweden (Affarsvarlden Gen)	205.9	236.8	201.2	+ 0.5	-48.6	-11.0	- 8.4
Switzerland (Swiss Market)	6,670.1	6,694.1	6,105.2	+ 1.2	-20.7	+ 3.9	+ 7.5
United States (DJIA)	10,243.7	10,635.3	9,618.2	+ 1.0	-12.6	+ 2.2	+ 2.2
(S&P 500)	1,091.0	1,172.5	1,049.5	+ 0.2	-28.6	- 5.0	- 5.0
(Nasdaq Comp)	1,725.6	2,059.4	1,573.8	+ 1.7	-65.8	-11.5	-11.5
Europe (FTSE Eurotop 300)*	1,235.5	1,279.7	1,185.5	+ 1.1	-27.5	- 2.0	- 0.2
Euro area (FTSE Ebloc 100)*	1,066.2	1,125.1	1,013.0	+ 1.5	-31.2	- 4.1	- 2.4
World (MSCI)†	982.1	1,024.4	937.0	+ 0.6	-32.2	na	- 2.1
World bond market (Salomon)‡	448.3	452.7	430.3	- 0.1	- 2.5	na	+ 2.0

*In euro terms. †Morgan Stanley Capital International index includes individual markets listed above plus eight others, in dollar terms. ‡Salomon Smith Barney World Government Bond Index, total return, in $ terms.

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Trade, exchange rates and budgets

May 16th 2002
From The Economist print edition

	Trade balance*, $bn latest 12 months	Current account $bn latest 12 mths	Current account The Economist poll % of GDP, forecast 2002	Current account The Economist poll % of GDP, forecast 2003	Exchange rate trade-weighted† May 15th	Exchange rate trade-weighted† year ago	Currency units per $ May 15th	Currency units per $ year ago	Currency units per £	Currency units per euro	Currency units per ¥100	Budget balance % of GDP 2002‡
Australia	+ 1.5 Mar	− 9.2 Q4	− 3.6	− 3.7	76.8	73.3	1.82	1.92	2.65	1.65	1.43	0.1
Austria	− 3.0 Feb	− 3.6 Feb	− 2.2	− 2.0	100.3	100.2	1.10	1.13	1.61	–	0.86	-0.3
Belgium	+ 11.5 Mar	+ 13.0 Dec	+ 4.8	+ 4.8	99.2	98.8	1.10	1.13	1.61	–	0.86	nil
Britain	− 48.0 Mar	− 25.1 Q4	− 2.1	− 2.1	106.0	106.1	0.69	0.70	–	0.62	0.54	-0.8
Canada	+ 37.6 Feb	+ 18.9 Q4	+ 2.1	+ 2.3	77.3	78.2	1.56	1.54	2.26	1.41	1.22	1.0
Denmark	+ 7.2 Feb	+ 4.1 Feb	+ 2.2	+ 2.0	102.2	101.5	8.20	8.44	11.9	7.44	6.41	2.2
France	+ 4.5 Feb	+ 24.4 Feb	+ 1.7	+ 1.7	101.8	101.4	1.10	1.13	1.61	–	0.86	-2.0
Germany	+ 92.3 Mar	+ 13.3 Mar	+ 0.4	+ 0.4	98.8	98.4	1.10	1.13	1.61	–	0.86	-2.8
Italy	+ 8.5 Feb	+ 1.7 Jan	+ 0.1	nil	72.6	72.4	1.10	1.13	1.61	–	0.86	-1.4
Japan	+ 72.6 Mar	+ 96.1 Mar	+ 2.5	+ 2.6	130.7	136.9	128	124	186	116	–	-8.0
Netherlands	+ 22.4 Feb	+ 11.8 Q4	+ 3.7	+ 4.0	98.1	97.7	1.10	1.13	1.61	–	0.86	0.1
Spain	− 37.9 Feb	− 15.1 Jan	− 2.2	− 1.8	74.4	74.1	1.10	1.13	1.61	–	0.86	-0.3
Sweden	+ 13.3 Mar	+ 7.4 Mar	+ 2.5	+ 2.8	75.7	76.8	10.2	10.3	14.8	9.23	7.96	2.1
Switzerland	+ 1.8 Mar	+ 24.6 Q4	+ 9.5	+ 9.6	113.8	107.4	1.61	1.73	2.34	1.46	1.26	na
United States	−423.2 Feb	−417.4 Q4	− 4.2	− 4.4	119.6	119.5	–	–	1.46	0.91	0.78	-1.0
Euro area	+ 50.3 Feb	− 5.8 Feb	+ 0.3	+ 0.4	79.2	78.3	1.10	1.13	1.61	–	0.86	-1.5
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*											
Finland	+ 12.4 Mar	+ 7.5 Mar	na	na	78.3	77.9	1.10	1.13	1.61	–	0.86	3.2
Greece	− 19.1 Dec	− 7.2 Dec	na	na	57.6	57.4	1.10	1.13	1.61	–	0.86	0.4
Iceland	+ 0.1 Mar	− 0.4 Q4	na	na	na	na	92.3	100	134	83.7	72.2	-0.5
Ireland	+ 32.2 Feb	− 1.1 Q4	na	na	87.7	87.0	1.10	1.13	1.61	–	0.86	0.1
Luxembourg	− 2.9 Feb	+ 0.9 Q4	na	na	99.2	98.8	1.10	1.13	1.61	–	0.86	2.2
New Zealand	+ 0.3 Mar	− 1.6 Q4	na	na	87.0	80.5	2.18	2.37	3.18	1.98	1.71	0.1
Norway	+ 24.7 Apr	+ 22.2 Feb	na	na	101.9	94.9	8.32	9.08	12.1	7.54	6.51	14.0
Portugal	− 13.6 Feb	− 10.1 Feb	na	na	89.4	89.2	1.10	1.13	1.61	–	0.86	-2.4

*Merchandise. Australia, Britain, France, Canada, Japan and United States imports fob, exports fob. All others cif/fob. †1990=100, Bank of England. ‡OECD forecast.

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Exchange-rate forecasts

May 16th 2002
From The Economist print edition

Exchange-rate forecasts

from J.P. Morgan Chase, currency units per $

	May 15th	3-month	12-month
Euro area*	0.90	0.91	0.92
Japan	128	126	126
Australia	1.83	1.80	1.74
Britain†	1.45	1.47	1.46
Canada	1.56	1.53	1.47
Denmark	8.23	8.22	8.06
Sweden	10.2	9.74	9.44
Switzerland	1.61	1.64	1.65
China	8.28	8.26	8.20
Singapore	1.81	1.79	1.74
South Korea	1,268	1,270	1,233
Brazil	2.51	2.55	2.53
Mexico	9.46	9.27	9.69
Poland	4.06	4.10	3.66
Russia	31.3	33.0	35.8
South Africa	10.2	10.8	12.9

*$ per †$ per £

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Overview

May 16th 2002
From The Economist print edition

Israel's economy has been mired in recession for over 12 months. In the year to March, GDP fell by 4.2%. But, despite the deteriorating security situation, output rose in the first quarter of 2002 at an annual rate of 2.4%. Public spending surged, driven by a big rise in defence spending.

Boosted by exports and government spending, industrial production in **China** jumped by 12.1% in the year to April. Industrial output in **Mexico** fell by 7.6% in the year to March.

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Emerging stockmarkets

May 16th 2002
From The Economist print edition

Although they have bounced back in recent months, emerging stockmarkets have still done worse than America's since January 1st 2000. The S&P 500 index has fallen by 25%. Morgan Stanley Capital International's emerging-market index has fallen by 29%.

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Economy

May 16th 2002
From The Economist print edition

	% change on year earlier						Latest 12 months, $bn				Foreign reserves* $bn, latest	
	GDP		Industrial production		Consumer prices		Trade balance		Current account			
China	+ 7.6	Q1	+12.1	Apr	– 1.3	Apr	+25.6	Apr	+21.2	2001§	226.7	Feb
Hong Kong	– 1.6	Q4	– 9.3	Q4	– 2.2	Mar	– 9.6	Mar	+12.0	Q4	110.9	Apr
India	+ 6.3	Q4	+ 2.4	Mar	+ 5.2	Mar	– 5.9	Mar	– 0.1	Q4	52.5	Apr
Indonesia	+ 2.9	Q4	– 2.2	Q3	+13.3	Apr	+26.0	Mar	+ 7.3	Q3	27.2	Mar
Malaysia	– 0.5	Q4	– 3.5	Mar	+ 2.1	Mar	+14.1	Mar	+ 6.9	Q4	31.5	Mar
Philippines	+ 3.8	Q4	+ 2.2	Feb‡	+ 3.6	Apr	+ 2.6	Feb	+ 4.9	Jan	14.9	Mar
Singapore	– 2.6	Q1	– 2.9	Mar	– 0.9	Mar	+ 5.3	Mar	+17.9	Q4	76.6	Apr
South Korea	+ 3.7	Q4	+ 4.4	Mar	+ 2.5	Apr	+ 9.3	Apr	+ 7.6	Mar	106.0	Mar
Taiwan	– 2.7	Q4	+ 0.4	Mar	+ 0.2	Apr	+18.3	Apr	+19.0	Q4	132.9	Apr
Thailand	+ 2.1	Q4	+ 8.4	Mar	+ 0.4	Apr	+ 3.2	Mar	+ 6.6	Mar	32.9	Mar
Argentina	–10.7	Q4	–16.7	Mar	+18.4	Apr	+ 9.8	Mar	– 4.4	Q4	12.8	Mar
Brazil	– 0.7	Q4	– 3.8	Mar	+ 8.0	Apr‡	+ 4.7	Apr	–19.8	Mar	36.7	Mar
Chile	+ 1.7	Q4	– 2.1	Mar	+ 2.5	Apr	+ 1.5	Mar	– 0.9	Q4	14.0	Feb
Colombia	+ 1.7	Q4	– 0.5	Feb	+ 5.7	Apr	+ 0.4	Feb	– 1.7	Q4	10.1	Mar
Mexico	– 2.0	Q1	– 7.6	Mar	+ 4.7	Apr	– 9.3	Mar	–17.1	Q4	46.2	Mar
Peru	+ 1.6	Mar	+ 0.3	Feb	+ 0.1	Apr	– 0.1	Feb	– 1.1	Q4	8.3	Mar
Venezuela	+ 2.8	Q3	+ 9.7	Jan	+18.7	Apr	+ 9.8	Q4	+ 4.4	Q4	6.6	Feb
Egypt	+ 4.9	2001†	+ 7.8	2001†	+ 2.4	Jan	– 8.6	Dec	– 0.1	Q4	12.6	Jan
Israel	– 4.2	Q1	– 6.9	Feb	+ 5.0	Apr	– 5.9	Apr	– 1.7	Q4	24.0	Apr
South Africa	+ 1.8	Q4	+ 3.9	Mar	+ 6.6	Mar	+ 3.8	Mar	– 0.2	Q4	6.0	Mar
Turkey	–10.4	Q4	+18.7	Mar	+52.7	Apr	– 7.4	Feb	+ 4.2	Jan	20.5	Mar
Czech Republic	+ 3.2	Q4	+ 4.1	Mar	+ 3.2	Apr	– 2.7	Mar	– 2.7	Q4	15.9	Apr
Hungary	+ 3.3	Q4	+ 4.2	Mar	+ 6.1	Apr	– 2.2	Mar	– 1.4	Mar	10.1	Apr
Poland	+ 0.3	Q4	– 3.2	Mar	+ 3.3	Mar	–11.1	Mar	– 7.2	Mar	26.1	Mar
Russia	+ 4.3	Q4	+ 3.7	Mar	+16.3	Apr	+45.0	Mar	+31.2	Q1	33.2	Mar
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*											
Pakistan	+ 3.3	2001†	+ 6.9	Dec	+ 3.3	Apr	– 1.0	Apr	+ 0.3	2001†	4.0	Mar
Saudi Arabia	+ 1.7	2001§	na		nil	Feb	+37.5	2001§	+ 8.3	2001	17.6	Mar

*Excluding gold, except Singapore; IMF definition. ‡New series. †Year ending June. §Economist Intelligence Unit estimate.

Text refers only to the first 25 countries listed

Sources: National statistics offices, central banks and stock exchanges; Thomson Financial Datastream; Economist Intelligence Unit; Reuters; Warburg Dillon Read; J.P Morgan Chase; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; FIEL; EFG-Hermes; Bank Leumi Le-Israel; Standard Bank Group; Garanti Bank; Deutsche Bank; *Russian Economic Trends*.

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Financial markets

May 16th 2002
From The Economist print edition

	Currency units			Interest rates	Stockmarkets	% change on		
	per $		per £	short-term	May 15th		Dec 31st 2001	
	May 15th	year ago	May 15th	% p.a.		one week	in local currency	in $ terms
China	8.28	8.28	12.0	na	1,668.4‡	-3.3	- 2.6	- 2.6
Hong Kong	7.80	7.80	11.4	1.95	11,838.4	+0.6	+ 3.9	+ 3.9
India	49.0	46.9	71.3	6.38	3,395.6	-1.1	+ 4.1	+ 2.4
Indonesia	9,240	11,408	13,449	16.81	538.9	-1.6	+ 37.5	+ 54.7
Malaysia	3.80	3.80	5.53	3.25	786.8	-1.0	+ 13.0	+ 13.0
Philippines	49.6	50.2	72.3	6.06	1,357.7	+0.9	+ 16.2	+ 20.8
Singapore	1.81	1.81	2.63	0.88	1,747.3	+0.7	+ 7.6	+ 10.0
South Korea	1,273	1,309	1,852	4.82	862.6	+2.1	+ 24.4	+ 28.4
Taiwan	34.5	33.0	50.2	2.55	5,910.7	+3.5	+ 6.5	+ 7.9
Thailand	42.9	45.3	62.4	2.13	375.8	-1.7	+ 23.7	+ 27.6
Argentina	3.24	1.00	4.72	na	370.2	-7.2	+ 25.3	- 61.3
Brazil	2.51	2.32	3.65	18.36	12,349.6	-2.1	- 9.0	- 16.2
Chile	653	605	950	4.08	5,223.5	-0.1	- 3.2	- 2.0
Colombia	2,300	2,379	3,347	9.56	1,149.8	+2.1	+ 7.4	+ 6.3
Mexico	9.48	9.16	13.8	6.87	7,402.8	-1.5	+ 16.2	+ 12.4
Peru	3.45	3.60	5.01	2.41	1,235.7	+0.3	+ 5.1	+ 5.1
Venezuela	1,001	714	1,456	25.00	6,943.0	+5.1	+ 5.7	- 20.0
Egypt	4.60	3.88	6.70	7.20	5,436.1	+1.4	+ 3.1	+ 2.5
Israel	4.80	4.14	6.99	2.73	380.4	+1.3	- 14.9	- 21.7
South Africa	10.2	7.99	14.9	11.65	11,501.6	+0.0	+ 10.2	+ 29.3
Turkey	1,395,500	1,123,500	2,031,150	43.00	11,402.2	-5.9	- 17.3	- 13.7
Czech Republic	33.4	38.8	48.7	3.82	468.0	+0.6	+ 18.6	+ 26.2
Hungary	269	293	392	8.66	8,742.0	-2.3	+ 22.6	+ 25.2
Poland	4.08	4.00	5.94	9.95	14,934.0	-0.0	+ 7.3	+ 3.9
Russia	31.3	29.1	45.5	23.00	402.4‡	+5.5	+ 58.6	+ 54.7
EMF (MSCI)*	1.00	1.00	1.46	na	356.5	+0.7	na	+ 12.3
EMBI+†	1.00	1.00	1.46	na	214.7	+0.2	na	+ 7.1

*Emerging Mkts Free. †J.P. Morgan Chase's Emerging Mkts Bond Index Plus. ‡In $ terms.
Sources: National statistics offices, central banks and stock exchanges; Thomson Financial Datastream; Economist Intelligence Unit; Reuters; Warburg Dillon Read; J.P Morgan Chase; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; FIEL; EFG-Hermes; Bank Leumi Le-Israel; Standard Bank Group; Garanti Bank; Deutsche Bank; *Russian Economic Trends*.

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